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IN THE

Supreme Court of the United States

October Term, 1979

No. 79-1251

HARRIS, KERR, FORSTER AND COMPANY,

Petitioner,

vs.

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner, the accounting firm of Harris, Kerr, Forster and Company, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on November 14, 1979.

OPINION BELOW.

The Opinion of the Court of Appeals, reported at 608 F.2d 377, appears as Appendix A hereto, accompanied by an order of January 3, 1980, modifying the Opinion. No opinion was rendered by the District Court for the Central District of California.

JURISDICTION.

The judgment of the Court of Appeals for the Ninth Circuit was entered on November 14, 1980. This peti-

tion for certiorari was filed within ninety (90) days of that date, no petition for rehearing having been filed. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED.

1. Whether the scienter requirement of §10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 is satisfied by a standard of "recklessness" which, as construed and applied by the Ninth Circuit Court of Appeals in the present case, sanctions liability for merely negligent conduct?

2. Whether the Ninth Circuit's "flexible duty" approach, as set forth in *White v. Abrams,* which permits the jury to determine both law and fact in federal securities fraud actions may be applied in this case as either a substitute or alternative for scienter requirement enunciated in *Ernst & Ernst v. Hochfelder*?

STATUTE AND RULE INVOLVED.

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. §78j(b), provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> "To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as

> necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Commission Rule 10b-5, 17 CFR §240.10b-5, provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security."

STATEMENT OF THE CASE.

A. The Parties to the Transaction.

Marconsult, Inc., a marine resources consulting firm, was formed in the late 1960's. The firm was consistently cash-poor, and did not prosper. (C.T. 987.) In 1970 new persons assumed management of the company with hopes of changing its fortunes. Despite reorganization and continued investment in research and development the company experienced no sudden turnaround, although management professed to see the beginning of such a turnaround in expected new contracts. (C.T. 532 *et seq.*)

Spectrum Financial Companies, a California corporation ("Spectrum") was general partner of two limited partnerships, Spectrum Leveraged Natural Gas I and II (hereinafter "SLNG I and II") formed in 1970 for the purpose of oil and gas exploration and development. (C.T. 4-5.) Each of ninety-eight high-income individuals (dentists and doctors) invested a minimum of $5,000 for a limited partnership interest in SLNG I or II apparently for the primary purpose of obtaining income tax shelter. (C.T. 74-81.)

B. The Agreement to Exchange.

In late 1971, when SLNG I and II held operating oil and gas wells (and therefore no longer served their primary tax purpose), Arnold G. Rudoff, an attorney-CPA and President of Spectrum, commenced negotiations with Marconsult with a view toward an exchange of the partnership interests. The negotiations consummated in a fully-integrated written agreement of January 5, 1972, by which Marconsult agreed to exchange its common stock and convertible promissory notes for the interests of Spectrum and the limited partners in order to improve its traditionally cash-poor situation. (C.T. 544; 953.) While the effective date of the exchange was January 1, 1972, the transaction was conditioned on the qualification of Marconsult securities with the California Commissioner of Corporations and approval of the exchange by 75% of the SLNG I and II voting interests. (C.T. 54-58.)

C. California Commissioner of Corporations' Approval of Transaction.

On March 6, 1972, Marconsult filed with the California Commissioner of Corporations an Application

for Permit to issue its common stock and convertible notes as called for in the January 5 contract. On May 16, 1972, the Commissioner's hearing took place and was attended by Mr. Rudoff and an attorney for Spectrum, among others. The financial information submitted by Marconsult showed that for the year ended August 31, 1971, apart from a nonrecurring gain of over $171,000, Marconsult operated at a substantial loss. (C.T. 532.)[1] A statement of income and expenses for the three months ending November 30, 1971, showed a net loss of $27,000. Certain officers of Marconsult, however, expressed their optimism for the future and made certain representations concerning Marconsult's expected revenue and earnings. (*E.g.*, C.T. 542-544.) On June 22, the Commissioner approved the transaction and issued a permit authorizing the exchange on the condition that certificates evidencing ownership of the securities bear a legend prohibiting sale or transfer without prior written consent of the Commissioner. (C.T. 619-622.) The following day Spectrum distributed copies of the permit to the limited partners of SLNG I and II and stated that it intended to proceed with the exchange as to its own interests. (C.T. 648.)

D. Petitioner's Qualified Opinion of Marconsult's Financial Status.

On March 8, 1972, Marconsult had retained the accounting firm of Harris, Kerr, Forster and Company ("HKF") to conduct an audit of the 16-month period

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[1]The loss was on the order of $150,000. Including the nonrecurring gain, Marconsult showed a net profit after taxes of but $23,693.92. (C.T. 777.)

from September 1, 1970, to December 31, 1971,[2] and to report on the 12-month calendar year of 1971. (C.T. 999.) During March and April HKF conducted its field work on the audit.

HKF was not requested to, nor did it prepare its audit for use in connection with the exchange (which it first learned of during the audit), was not informed of the May 16 hearing date before the Commissioner of Corporations and did not participate in the hearing, and was not informed that audited financial statements would be submitted to the Commissioner or used in connection with the exchange. (C.T. 438.) Subsequent to the hearing date HKF delivered to Marconsult its qualified opinion letter and accompanying financial statements for calendar year 1971. Marconsult did not furnish this information to anyone outside the company.

In early July, 1972, Marconsult's treasurer requested HKF to issue a report on the 16-month period covered by the audit, and this report was prepared and sent to Marconsult (appearing as Appendix B).[3] The HKF opinion was strongly qualified, reading:

> "Certain investments of the Company and the capitalized development costs, which are further discussed in Notes 2 and 3, represent a significant portion of the total assets of the Company at December 31, 1971. Recovery of the investments and development costs is dependent upon the success of the Company in obtaining future, as well as profitable, projects in these areas.
>
> "In our opinion, subject to the recovery of these costs as described in the preceding paragraph, such financial statements present fairly the financial position of Marconsult, Inc. at December 31, 1971 and the results of their operations for the period then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (Note 1)."

[2]Marconsult had elected to change from an August 31, to December 31 year end. The changeover to a calendar year created a "stub period" of September 1, 1970, to December 31, 1970.

[3]The opinion letter is dated April 24, 1972. This reflects the date field work on the audit was completed, not the date the letter was prepared.

Note 1 informed: "The Company elected to change its reporting period from an August 31 to December 31 year end. Accordingly, the statement of income and accumulated deficit reflects the operations from September 1, 1970 to December 31, 1971. The gross revenue and net loss for the four months ended December 31, 1970 amounted to $294,529 and $(27,340) respectively."

Far from lending itself to the rosy projections of Marconsult management, the financial statements reflected, *inter alia*, current cash at slightly over $5,000, total income for the 16-month period of $351,873 (including the $294,529 of the stub period), accumulated deficit at the beginning of the period of $73,453 and accumulated deficit at the end of $346,397.

E. Limited Partners' Approval of Transaction Without Reliance on 16-Month Report.

By July 10, 1972, the requisite 75% approval of the SLNG I and II limited partners was obtained. (C.T. 596-603.) None of the accepting limited partners had seen the 16-month report. The actual exchange of interests took place in October, 1972. In the interim, Marconsult applied for removal of the restrictive legend

on its securities required by the June 22 permit. (C.T. 1074.) Notwithstanding the precarious financial condition of Marconsult as shown in the 16-month report, which was submitted with the application and confirmed the unaudited financial statements previously submitted, the legend condition was removed. (C.T. 1077.)

F. The Lawsuit.

Marconsult continued its operations, acquiring the George F. Casey Company in early 1973. Later that year, however, it became apparent that the company's earlier revenue and income projections were seriously wide of the mark. Thereafter Marconsult entered bankruptcy.

Spectrum was quick to charge fraud. In the operative fourth amended complaint, Spectrum accused Marconsult and its officers, the accountant who had prepared Marconsult's 1969 and 1970 audits, and HKF, along with others of (1) violation of federal securities laws, (2) violation of state securities laws, (3) fraud, and (4) money lent and received. Six of the SLNG I and II limited partners intervened in the action. When their motion for certification of a class action was denied, other limited partners were urged to, and fifty-six of them did, file a separate action (the "Barbieri action"), with a complaint identical to that of Spectrum. The actions were consolidated. Jurisdiction of the District Court was invoked under 15 U.S.C. sections 77v and 78aa.

As against HKF, the various complaints charged that HKF had committed material misrepresentations or omissions in the 16-month report or had somehow aided and abetted Marconsult's alleged misrepresentations or omissions. Essentially, it was alleged that the 16-month report failed to sufficiently call attention to the precarious financial condition of Marconsult.

G. Motion for Summary Judgment.

Following extensive discovery by all parties, in late 1975 HKF unsuccessfully moved for summary judgment against the intervenors in the Spectrum action on the ground they had not relied on the HKF report in agreeing to the exchange. The motion was denied. A few months later this Court's decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976) was released, and HKF moved for summary judgment based on the principles of that case. Because the complainants raised no triable issue of fact regarding scienter as required in *Hochfelder,* summary judgment was granted and the actions dismissed as to HKF.

H. The Judgment and Opinion of the Court of Appeals.

The Ninth Circuit Court of Appeals reversed the grant of summary judgment and remanded for reconsideration in light of its decision in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir. 1978), cert. den. 439 U.S. 970, which established a "knowing or reckless" standard for scienter.

Further, the Court inferred from the denial of the first motion for summary judgment that the District Court concluded there were genuine issues of material fact under the then-prevailing "flexible duty" analysis of *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974), but not under *Ernst & Ernst v. Hochfelder* which disapproved *White v. Abrams.* Over the objection of one member, who correctly identified the flexible duty test as a negligence test, the Court expressly resurrected the flexible duty test, and, apparently as an alternative basis for decision, held summary judgment inappropriate because it found a triable issue of fact under that test.

REASONS FOR GRANTING THE WRIT.

I

THE OPINION OF THE COURT OF APPEALS CONFLICTS WITH THE LANGUAGE AND PURPOSE OF SECTION 10(b) AS CONSTRUED IN ERNST & ERNST v. HOCHFELDER.

A. Actions Under Section 10(b) and Rule 10b-5 Must Be Supported by Allegations and Proof of Defendant's Intent to Deceive, Manipulate or Defraud. As a General Rule, Recklessness Alone Cannot Suffice.

In *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185, this Court held that a private cause of action for damages will not lie under §10(b) and Rule 10b-5 in the absence of an allegation of scienter. The plain terms[4] of §10(b) dictated both the holding and the Court's definition of scienter—"intent to deceive, manipulate, or defraud." (*Id.* at 193.)

Because "[t]he language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception" (*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473 (1977)), negligence cannot give rise to liability under §10(b) and Rule 10b-5. For the same reason, recklessness should not give rise to liability. First, it is difficult to imagine how one who recklessly misstates or omits to state facts could possibly be said to have done so as a "manipulative or deceptive device or contrivance." When it is also recalled that the statute refers to the use or employment of such a device or contriv-

[4]"The starting point in every case involving construction of a statute is the language itself." (*Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 756 (Powell, J., concurring) (1975).)

ance, it should follow that recklessness does not fall within the scope of the statute. "To use or employ" is the language of intentionality.[5] These are goal-directed terms meaning "to utilize toward some end." (See *Webster's New International Dictionary* (2d ed. 1934).) Recklessness is the very antithesis of goal-directed conduct since it is conduct heedless of its consequences. (*Ibid.*)[6]

However, in *Hochfelder* this Court left open the question whether, in some circumstances, recklessness could satisfy the scienter requirement: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5." (*Id.* at p. 193, n. 12.) As the instant case illustrates, this open question has been exploited by the lower courts, especially the Ninth Circuit, to carve an exception as broad as the *Hochfelder* rule. Despite "the language of §10(b) which so clearly connotes intentional misconduct" (*Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185, 201) a general recklessness (*i.e.,* non-intentional) standard now prevails.

[5]In *Hochfelder,* footnote 20, this is suggested without amplification.

[6]The inappropriateness of a general recklessness standard is, perhaps, most readily seen when a defendant is charged, as is Petitioner (at least in part), with having aided and abetted in the commission of a §10(b) violation. What, precisely, can it mean to say someone recklessly aided and abetted someone else? And what if the liability of the person who was aided and abetted was in turn based only on recklessness?

B. The Lower Courts and Especially the Ninth Circuit in the Instant Case Have Adopted a General Recklessness Standard Which Vitiates Hochfelder.

The eye of the needle in *Hochfelder's* footnote 12 now readily accommodates camels of all sizes, so long as they are labelled "recklessness."

This trend apparently began when the lower federal courts started to read footnote 12, to the exclusion of the rest of the opinion, as though it said "we need not address here the question whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5," omitting to note that the narrow question the Court left open was whether "*in some circumstances*" recklessness might be sufficient. With footnote 12 thus distended and *Hochfelder* thus distorted, the lower courts began accepting recklessness as adequate scienter in *all* circumstances in §10(b) actions. (See, *e.g., Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1023-1024 (6th Cir. 1979); *Nelson v. Serwold, supra,* 576 F.2d 1332, 1337; *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 44 (2d Cir. 1978), cert. den. 439 U.S. 1039;[7] *Coleco Industries Inc. v. Berman,* 567 F.2d 569, 574 (3rd Cir. 1977), cert. den. 439 U.S. 830; *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), cert. den. 435 U.S. 952; *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir. 1977), cert. den. 434 U.S. 875.) Few courts have even acknowledged that the adoption of a general recklessness standard threatened re-introduction of the negligence approach rejected in *Hochfelder.* (See *Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977).)[8]

[7]By its terms *Rolf* endorsed the recklessness standard only in cases involving a defendant who owed a fiduciary duty to the plaintiff. For another illustration of this "sliding scale" approach to scienter see *Edward & Hanly v. Wells Fargo Securities, Etc.,* 602 F.2d 478 (2d Cir. 1979).

These cases focus on footnote 12 of *Hochfelder* and proceed by parsing and teasing the rest of the opinion to reach results precisely contrary to the holding of the case. *Nelson v. Serwold, supra,* 576 F.2d 1332, the Ninth Circuit's first recklessness ("knowing or reckless") case, perhaps summarizes the results of this process. There the court declared that *Hochfelder's* "terminology, analysis and citation to authority . . . lend credence to a broad interpretation of scienter" and concluded "*Ernst & Ernst*, we think, only went so far as to eliminate negligence as a basis for liability." (*Id.* at p. 1337.)

Nowhere in these cases does one find any consideration of the terms of §10(b) which should have been the starting point of inquiry. Thus, in some courts

[8]It seems some courts attempted to define "recklessness" in ostensibly stringent fashion to partially comport with *Hochfelder.* (*E.g., Franke v. Midwestern Oklahoma Development Authority,* 428 F.Supp. 719, 725 (W.D. Okl. 1976).) Subsequently, all but the merest pretense of complying with *Hochfelder* disappeared. For example, in *Rolf v. Blyth, Eastman Dillon & Co., Inc., supra,* 570 F.2d 38, the majority "patche[d] together watered-down notions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed by the Supreme Court in *Ernst & Ernst v. Hochfelder*" (*id.* at 50, Mansfield, J., dissenting). In *Mansbach v. Prescott, Ball & Turben, supra,* 598 F.2d 1017. 1025, the court expressly purported to limit *Hochfelder*: "We believe that *Hochfelder* should be read to go no further than its specific holding that mere negligence is not enough for liability." And in the instant case the Ninth Circuit readopted the "flexible duty" test of *White v. Abrams, supra,* 495 F.2d 724, which was identified in footnote 12 of *Hochfelder* as one of the cases overruled by that case, as the Ninth Circuit itself previously recognized in *Ritzau v. Warm Springs West,* 589 F.2d 1370, 1374 (9th Cir. 1979). As Judge Ferguson observed in this case (Appendix A, p. 18): "[T]he flexible duty negligence standard is just that—a negligence standard."

plaintiff need only allege that a defendant "should have known" certain facts (see *Stern v. American Bankshares Corp.*, 429 F.Supp. 818, 827 (E.D. Wisc. 1977)); he may have the jury instructed that recklessness means "carelessness approaching indifference" (*Hoffman v. Estabrook & Co., Inc.*, 587 F.2d 509, 516 (1st Cir. 1978)),[9] and he may satisfy the scienter burden of proof upon showing that defendants "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary efforts." (*Kiernan v. Homeland, Inc.*, ... F.2d .... (9th Cir. 76-1454, filed January 15, 1980).)

If *Hochfelder* is to remain law in fact, not just in name, it must be revitalized. The present case raises the issue squarely and provides an appropriate vehicle for such revitalization.

C. There Is No Definition of Recklessness Consistent With Hochfelder Under Which Petitioner May Be Held Liable to Respondents.

Even if, in some possibly conceivable circumstances, recklessness might be sufficient scienter for liability under §10(b) and Rule 10b-5, the definition of recklessness cannot, consistent with *Hochfelder,* be stretched so far as to sweep in Petitioner under the alleged facts of this case. As found by the District

[9]As appears from these cases, the appellate courts have for the most part either refrained from defining "recklessness" (see *Mansbach v. Prescott, Ball & Turben, supra,* 598 F.2d 1017, 1025; and see Appendix A, page 14) or done so in either impossibly vague terms or terms which bear strong resemblance to ordinary negligence. In either case, the question is effectively left entirely to the fact-finder to settle under whatever personal construction may be made of the law.

Court, the complainants in this action, despite numerous opportunities to do so, failed to allege or show that Petitioner intended to deceive, manipulate, or defraud Spectrum or the limited partners of SLNG I and II. The most they showed was that Petitioner, while fully and fairly describing (for Marconsult) Marconsult's precarious financial condition, did not believe the facts warranted a conclusion that Marconsult was not a going concern; in other words, they showed only arguable negligence.

If recklessness can ever satisfy the scienter requirement, surely such recklessness must be at least the functional equivalent of intent. (See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968), Friendly, J., concurring (en banc), cert. den. sub nom. *Coates v. SEC,* 394 U.S. 976.) If functional equivalence of intent is the proper test, then the District Court's determination that the action could not proceed for lack of the element of scienter must be taken to foreclose consideration under a recklessness standard because there is no evdence of any conduct by Petitioner, reckless or otherwise, which meets this test. Indeed, it is difficult to pinpoint what precisely Petitioner is charged with doing recklessly. It was retained to audit a 16-month period. As requested, it prepared a report on the 12-month calendar year and then on the entire audited period. The 16-month financial statement fairly reflected Marconsult's precarious financial condition; the qualified opinion letter called attention to the fact that a large proportion of Marconsult's assets were of a speculative nature; Note 1 of the financial statements (referenced in the opinion letter) showed that for calendar year 1971

Marconsult had very little income and had suffered a substantial loss.

This was the same story shown in the financial statements submitted to the Commissioner of Corporations who remarked on Marconsult's dubious financial picture. Indeed, Marconsult had shown a profit in only one year of its five-year existence. (C.T. 987.) Counsel for Spectrum admitted that Marconsult's income for the preceding two years had not been "anything to write home about" (C.T. 558) but still argued in favor of the exchange.

Petitioner fairly set forth the financial condition of Marconsult for the 16-month period it had audited; surely it could not be expected to know whether Marconsult's new management was in a position to make the turnaround they hoped for. Yet the Court of Appeals apparently agreed with Respondents that Petitioner could be found to have acted recklessly by failing to state that Marconsult was not a going concern—when it had been a going concern on essentially the same footing for years and continued as a going concern for more than a year afterwards. If Petitioner could be found liable on this basis, any judgment call could be considered reckless as long as plaintiffs can find an expert who says he would have called it another way.[10]

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[10]In this case, for example, Respondents found someone who apparently would testify that in his opinion Petitioner did not act in accordance with generally accepted accounting principles. There is no indication he could or would testify to anything more than negligence. On the other hand, Petitioner was prepared to produce senior members from two of the "Big Eight" accounting firms and an Associate Dean from the UCLA Graduate School of Business to testify that the 16-month financial statements were prepared in conformity with generally accepted accounting principles and that the qualified opinion letter was proper in the circumstances.

Reconsideration of the summary judgment for Petitioner is merely an invitation to the trial court to construe alleged negligence as recklessness as scienter.

Petitioner respectfully submits that the time has arrived for this Court to reaffirm the plain meaning of *Hochfelder*, by granting this petition and reversing the judgment of the Court of Appeals or, if this Court wishes to reconsider its decision in *Hochfelder*, to do so now and end the continuing confusion and inconsistency current in this important and active area of the law.

II

THE FLEXIBLE DUTY APPROACH ADOPTED IN THE DECISION BELOW CONFLICTS IN PRINCIPLE WITH THE DECISIONS OF THIS COURT. IT IS A SHIFTING AND HIGHLY FACT-ORIENTED ANALYSIS WHICH PREVENTS UNIFORM ENFORCEMENT OF FEDERAL SECURITIES LAWS.

A. White v. Abrams Was Overruled by Ernst & Ernst v. Hochfelder.

In *White v. Abrams, supra,* 495 F.2d 724, the Ninth Circuit Court of Appeals purported to redefine the elements of a §10(b) and Rule 10b-5 action, stating (at pp. 734-735): "[W]e reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that Rule 10b-5 imposes on this particular defendant." The Court explained this flexible duty approach as follows (at pp. 735-736):

> "Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defend-

ant's duty under Rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question." (Footnotes omitted.)

In *Hochfelder,* footnote 12, page 193, *White v. Abrams* and its flexible duty analysis were expressly identified as antithetical to the holding of the case. The Ninth Circuit itself has inconsistently recognized and denied the continued viability of *White v. Abrams.* For example, in *Crocker Citizens National Bank v. Control Metals Corp.,* 566 F.2d 631, 632, n. 2 (9th Cir. 1977), the court asserted that "[a]bsent the possibility of liability based upon negligence, *Hochfelder* is not inconsistent, on its facts, with the flexible duty standard established in *White v. Abrams.*" But in *Ritzau v. Warm Springs West, supra,* 589 F.2d 1370, 1374, the court admitted that *Hochfelder* had "explicitly rejected" the flexible duty approach. Nevertheless, in *Zweig v. Hearst,* 594 F.2d 1261, 1268, n. 13 (9th Cir. 1979) and in the instant case *White v. Abrams* has been resurrected, Phoenix-like, from the ashes of *Hochfelder.*

As Judge Ferguson said (Appendix A, p. 18): "[T]he flexible duty negligence standard is just that—a negligence standard." If the instant decision escapes review, this negligence standard is once again, *Hochfelder* notwithstanding, the law of the Ninth Circuit.

B. As Illustrated by Its Application to Petitioner, the Flexible Duty Approach Leaves It to the Jury to Decide Both Fact and Law in a Manner Completely Inconsistent With the Dictates of Federal Securities Laws.

The flexible duty approach is, by its terms, a scienter substitute. It attempts to bring the entire range of common law fraud plus breach of fiduciary duties within the ambit of §10(b) actions. (*Cf., Santa Fe Industries, Inc. v. Green, supra,* 430 U.S. 462.) This approach essentially enables the jury to determine the law as well as the facts. (A. Bromberg, *Securities Law, Fraud-SEC Rule 10b-5,* §8.5 (1975).) Its potential for confusion in enforcement of federal securities law has been noted. (*Dupuy v. Dupuy,* 551 F.2d 1015 (5th Cir. 1977), cert. den. 434 U.S. 911.) In virtually every case it mandates "a shifting and highly fact-oriented" disposition of the issue of who may bring a damages claim for violation of §10(b) against whom and on what basis. (See *Blue Chip Stamps v. Manor Drug Stores, supra,* 421 U.S. 723, 755.) Even worse, "[a] jury verdict will be hard to overturn for insufficiency of evidence since the specific facts giving rise to the duty will probably be unidentifiable." (A. Bromberg, *op. cit., supra,* §8.5.) Whatever lip service is paid *Hochfelder,* the flexible duty approach leaves it to the jury to determine the operative elements of §10(b) and Rule 10b-5 actions, at the same time making such determination essentially unreviewable.

The Court of Appeals' illustration of how the flexible duty approach applies to Petitioner in this case exemplifies the broad reach of this analysis, as either a substitute or alternative for scienter.

Of the five basic elements of the flexible duty approach, the Court of Appeals purported to apply four to Petitioner, acknowledging that "defendant's initiation of the transaction" was inapplicable. Considering the remaining four elements the Court found:

(a) Relationship of Plaintiff to Defendant—"Indirect"; supposedly Petitioner had "strong incentive" to make Marconsult look good on paper to assure payment of its fee, therefore also satisfying element (3), benefit to defendant.[11]

But by any reasonable measure there was simply no relationship between Petitioner and Respondents. As Judge Ferguson said (Appendix A, p. 18): "There is no real relationship between plaintiff and defendant here . . . thus the Court is confronted with the necessity of manufacturing the relationship. . . ."

(b) Defendant's access to information—"It goes without saying that an accountant has greater access to a company's financial data than a potential purchaser." The point is irrelevant.[12] The 16-month financial statement fully discloses Marconsult's financial condition; it reflects the change from fiscal to calendar year accounting periods; it separately states income and loss for the stub period; the opinion letter reveals the questionable nature of the bulk of Marconsult's assets. Respondents really claim that on the facts as

[11]The only reference in the record to Petitioner's fee for the Marconsult audit is that it was to be approximately $2,500.

[12]Respondents could have used the subpoena power of the Commissioner of Corporations to obtain any information they needed. The Court's statement that "they would not have obtained the data as easily as could HKF, nor would they be as skilled in interpreting the raw data" is completely conjectural and presumes, contrary to the record, that Respondents were unassisted in their investment decisions.

shown Petitioner should have adjudged Marconsult not to be a going concern. Whether Petitioner should or should not have done so involved judgment not further information.

(c) Defendant's awareness of Plaintiff's reliance—"If appellants relied on HKF's statement, it is logical to conclude that appellants relied on HKF, and that HKF knew of this reliance."

First, the Court itself noted in its statement of facts that "Spectrum received the requisite 75% approval on July 10. None of the accepting limited partners had seen any of Marconsult's financial statements, and the 16-month report had not been disseminated outside Marconsult as of that date." Second, while Petitioner knew that the exchange was conditioned upon approval of the Commissioner of Corporations, this approval was given on June 22, before the 16-month report was prepared. The acceptance by Spectrum and the SLNG I and II limited partners was made following issuance of the permit with the restrictive legend condition.[13] Accordingly, it is neither logical nor permissible to conclude either that Respondents relied on any statement of Petitioner, or if there had been such reliance, that Petitioner could have known of it.

On the basis of this analysis the court concluded that there was a triable issue of fact whether Petitioner owed Respondents any duty. Summary judgment was therefore held inappropriate, despite the fact summary

[13]Respondents have contended that the exchange contemplated free transferability of Marconsult stock. The written agreement, however, contains no such condition and states that it "contains the entire agreement between the parties." In any event, there is no suggestion that Petitioner was aware of any terms of the agreement not reduced to writing.

judgment had been granted because Respondents failed to raise any triable issue of fact regarding scienter.

As the present case illustrates, the flexible duty approach is so flexible it creates the potential for unforeseen and essentially unlimited liability, particularly on the part of the accounting profession. That the "overall impact of *Abrams* is to extend the range of liability in individual Section 10(b) actions" (*In re U.S. Financial Securities Litigation*, 64 F.R.D. 443, 453 (S.D. Cal. 1974)) could not be more forcefully brought home by its employment in this case.

The flexible duty approach has no place in §10(b) actions either as a substitute for or as an alternative to the scienter requirement as explained in *Hochfelder*. Petitioner respectfully submits that the previous decisions of this Court and the uniform application of the federal securities laws call for the granting of the instant petition and reversal of the decision below.

CONCLUSION.

Ernst & Ernst v. Hochfelder introduced sorely-needed clarification and certainty to actions under §10(b) and Rule 10b-5, holding scienter, *i.e.*, intent to deceive, manipulate or defraud, to be a *sine qua non* of such actions. In just a few years, however, pre-*Hochfelder* confusion and inconsistency has reappeared and any meaningful definition of scienter has given way to "recklessness" and "flexible duty" which both theoretically and as applied in this case impose liability for negligence.

In enacting §10(b), Congress spoke concisely and plainly; it did not create a private right of action under the statute. So long as this Court sanctions the *judicially-created* private right of action under §10(b)

and Rule 10b-5, it must, in fairness, act as regular arbiter of the scope of such proceedings. It is, therefore, essential that this Court again address this issue to assure that the ever-expanding scope of §10(b) and Rule 10b-5 actions remains true to Congressional purposes.

Accordingly, Petitioner respectfully submits that if *Hochfelder* is to be law, as it should, it requires reaffirmation and revitalization through reversal of the decision in this case.

Respectfully submitted,

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APPENDIX A.

Order.

United States Court of Appeals for the Ninth Circuit.

Spectrum Financial Companies, Plaintiff-Appellant, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees.

Allen L. Barbieri, et al., Plaintiffs-Appellants, James E. Nevitt, Intervenor-Appellant, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2546. DC No. CV 74-3458-R and CV 75-2466-R, (Manuel Real) Central District of CA.

Spectrum Financial Companies, Plaintiff, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2651, DC No. CV 75-2466-R.

Filed Jan. 3, 1980.

Before: Wright and Ferguson, Circuit Judges; and Hoffman,* District Judge.

The opinion filed on November 14, 1979 is hereby amended as follows:

On page 5, line 7, the word "pleadings" is deleted.

On page 6, line 26, the words "pleadings and" are deleted.

On page 7, lines 6-8, the clause is corrected to read, "*this court delimited the duty owed by a given defendant to a given plaintiff.*"

Opinion.

In the United States Court of Appeals for the Ninth Circuit.

Spectrum Financial Companies, Plaintiff-Appellant, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2546.

Allen L. Barbieri, et al., Plaintiffs-Appellants, James E. Nevitt, Intervenor-Appellant, v. Marconsult, Inc., et al., Defendants-Appellees. Spectrum Financial Companies, Plaintiff, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al. Defendants-Appellees. No. 76-2651.

Filed Nov. 14, 1979.

Appeal from the United States District Court
for the Central District of California

Before: WRIGHT, Circuit Judge; HOFFMAN, Senior District Judge;* and FERGUSON, District Judge.**

WRIGHT, Circuit Judge:

Spectrum Financial Companies, the general partner of two limited partnerships, sued under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), and § 17(a) of the Securities Exchange Act of 1933, 15 U.S.C. § 77g (1976), alleging that Marconsult, Inc. and its accounting firm, Harris, Kerr, Forster and Company (HFK), made false and misleading statements regarding the value of Marconsult stock which Spectrum's limited partners received in exchange for oil and gas leases. Several limited partners intervened.

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*Of the Eastern District of Virginia.

**Of the Central District of California.

The district court refused to certify as a class Spectrum and its limited partners and granted HKF's motion for summary judgment.

We affirm the denial of class certification and reverse the grant of summary judgment. The case is remanded for reconsideration in light of *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978).

FACTS

In January, 1972, Spectrum entered into an agreement with Marconsult. The limited partners agreed to exchange their interests in oil and gas wells for common stock and debentures of Marconsult. The agreement was conditioned upon qualification of the securities with the California Commissioner of Corporations and upon approval of the exchange by 75% of the limited partners.

In March, 1972, Marconsult applied to the Commissioner for a permit to issue its common stock and convertible notes to Spectrum. Two days later, Marconsult hired HFK to audit its financial condition and render an opinion for the 1971 calendar year.

On May 8, HKF delivered to Marconsult draft copies of a financial statement for the calendar year 1971, together with its audit report dated April 24, 1972. The 12-month statement was unfavorable, disclosing that Marconsult had but $57,000 in sales and had suffered a loss of almost $250,000 during the year.

The Commissioner's hearing took place on May 16. Marconsult did not distribute the financial statement to Spectrum and the limited partners or submit it for the consideration of the Department. Following the hearing, the Deputy Commissioner indicated that

the application stood submitted pending the filing of additional financial data. HKF delivered to Marconsult its opening letter, with financial statements, on May 24.

The report was furnished to no one outside Marconsult. Instead, the company requested HKF to prepare and certify new financial statements covering a 16-month period from August 31, 1970 to the end of 1971.

Meanwhile, despite the fact that no additional financial data were submitted to the Department, the permit to issue securities was granted on June 22. It contained a legend severely restricting the transfer of the securities in the limited partners' hands.

HKF delivered the 16-month financial statement to Marconsult in early July. It incorporated more than $200,000 of business conducted during the four months before the beginning of the 1971 calendar year. As a result, it was considerably more favorable than the 12-month report. HKF's new opinion letter followed on July 18.

Spectrum received the requisite 75% approval on July 10. None of the accepting limited partners had seen any of Marconsult's financial statements, and the 16-month report had not been disseminated outside Marconsult as of that date. On August 17, nevertheless, Marconsult applied to the Commissioner for an order removing the restriction on transfer, and the 16-month statement was submitted as part of the application. The Commissioner removed the restriction.

The exchange took place in October 1972. In July 1973, it was apparent that Marconsult had fallen dras-

tically short of its income projections and was virtually insolvent.

Spectrum filed suit, alleging that Marconsult and HKF violated federal securities laws by failing to disclose the shaky foundation of Marconsult's stock. Spectrum's limited partners moved for an order certifying them as a class. The motion was denied as was a motion for interlocutory appeal. Fifty-six of the 92 nonparty limited partners then filed a new action, and the two actions were consolidated for trial.

HKF moved unsuccessfully for summary judgment in December 1975. In March 1976, the Supreme Court decided *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). HKF renewed its motion on the basis of the scienter requirement of that case and this time summary judgment was granted.

SUMMARY JUDGMENT

Summary judgment is appropriate only where there is no genuine issue as to any material fact. Fed. R. Civ. Proc. 56; *Lane Bryant v. Maternity Lane,* 173 F.2d 559, 565 (9th Cir. 1949). All inferences that can be drawn from the pleadings, depositions, admissions, and affidavits on file must be viewed in a light most favorable to the party opposing summary judgment. *United States v. Diebold, Inc.,* 369 U.S. 654 (1962).

A genuine issue must be predicated on a viable legal theory. *McGuire v. Columbia Broadcasting System, Inc.,* 399 F.2d 902, 905 (9th Cir. 1968). In this circuit, prior to *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), scienter was not a necessary predicate for liability under § 10(b) and Rule 10b-5. *See, e.g., White v. Abrams,* 495 F.2d 724, 734-

35 (9th Cir. 1974). We applied a "flexible duty" standard incorporating many factors to determine whether the defendants had a duty to disclose information relevant to the purchase or sale of securities. *Id.*

The district court denied summary judgment under the applicable Ninth Circuit standard, but granted it after *Hochfelder* clearly established that scienter is an element of Rule 10b-5 violations. Because this change in the applicable legal standard was the only event intervening between the denial and grant of summary judgment, we must assume that the trial court believed there were genuine issues of material fact under the old standard but that appellants failed to establish a genuine issue with respect to scienter.

Scienter

Appellants argue that the trial court erred in interpreting too strictly the scienter requirement. They contend that the element of scienter may be established by proof of reckless behavior, and that the pleadings and depositions on file raise a genuine issue of material fact as to whether HKF acted recklessly in supplying Marconsult with the 16-month statement.

In *Hochfelder,* the Court reserved the question whether "reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 425 U.S. at 193-94 n.12. This court answered the question affirmatively in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978).

Nelson contains a thorough discussion of the scienter requirement and the effect of *Hochfelder.* We concluded that "recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate

and cold-blooded' " would support liability under § 10(b) and Rule 10b-5. *Nelson v. Serwold,* 576 F.2d at 1338. Our holding is in accord with those of other circuits. *See, e.g., Edward J. Mawod & Co. v. Securities & Exch. Co'mn,* 591 F.2d 588, 596 (10th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 46 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

The district judge did not have the benefit of our decision in *Nelson* when he granted summary judgment. He did not indicate whether he examined the pleadings and depositions in light of a recklessness standard or required some stricter showing of intent. We believe that he should have the opportunity to determine, in the first instance, whether appellants have raised a genuine issue of material fact with respect to whether HKF acted recklessly. We must reverse the grant of summary judgment and remand for reexamination in light of *Nelson v. Serwold.*

Duty to Disclose

Beyond the issue of whether or not appellees were "reckless" is the question of whether they had any duty to disclose material information to appellants. In *White v. Abrams,* 495 F.2d 724, 735-6 (9th Cir. 1974), this court delimited the duty owed by a given plaintiff to a given defendant. Our recent decision in *Zweig v. Hearst Corp.,* 594 F.2d 1261 (9th Cir. 1979), restated the *White* "flexible duty standard":

> [these] factors are relevant in determining the scope of the duty to disclose material facts under Rule 10b-5: (1) the relationship of defendant to plaintiff; (2) defendant's access to the informa-

> tion as compared to that of plaintiff; (3) defendant's benefit derived from the relationship; (4) defendant's awareness of whether plaintiff was relying on their relationship in making his or her investment decisions; and (5) defendant's activity in initiating the transaction in question.

Id. at 1268.

A brief application of the present facts to this standard reveals that there was at least a triable issue of fact as to whether appellees owed appellants any duty.

1. *Relationship of Plaintiff to Defendant.*

While the relationship was indirect, it surely existed. HKF knew that a buyer had been found for what was essentially worthless stock. It also knew that without a buyer for its stock, Marconsult would not be in a position to pay HKF's fee. HKF's strong incentive to make Marconsult "look good" on paper created a relationship with any potential buyer not unlike the relationship in *Zweig,* where a financial columnist had a strong incentive to make a particular merger appear attractive to his readers. We there held that the columnist owed a duty to disclose to his readers his interest in the merger.

2. *Defendant's Access to Information.*

It goes without saying that an accountant has greater access to a company's financial data than a potential purchaser. Appellees note that the limited partners could have obtained any needed information by utilizing the subpoena power of the Commissioner of Corporations. Even if they had done so, however, they would not have obtained the data as easily as could HKF, nor would they be as skilled in interpreting the raw data.

3. *Benefit to Defendant.*

As noted above, in light of Marconsult's bleak financial picture, it seems clear that HKF's fees might not have been paid had a buyer not been found.

4. *Defendant's Awareness of Plaintiff's Reliance.*

In initially approving the exchange, the Commissioner severely restricted the transferability of the stock. After he read the 16-month financial statement prepared by HKF, he removed the restriction. This gave rise to a triable issue of fact as to the impact of the financial statement both on the Commissioner and on appellants. As noted earlier, the entire transaction was conditioned on the Commissioner's approval, as HKF well knew. If appellants relied on HKF's statement, it is logical to conclude that appellants relied on HKF, and that HKF knew of this reliance.

5. *Defendant's Initiation of the Transaction.*

This factor is clearly not relevant here, as HKF was consulted only after the transaction was under way. Nevertheless, enough of the factors comprising the "flexible duty standard" are present to conclude that there is a triable issue of fact as to whether or not HKF owed a duty to appellants. Summary judgment was therefore inappropriate.

CLASS CERTIFICATION

Appellants also protest the district court's denial of class certification.

Rule 23(a) of the Federal Rules of Civil Procedure sets forth these prerequisites to a class action:

> (1) the class must be so numerous that joinder of all members is impracticable,

(2) there must be questions of law or fact common to the class,

(3) the claims or defenses of the representative parties must be typical of the claims or defenses of the class, and

(4) the representative parties must fairly and adequately protect the interests of the class.

The determination whether a class should be certified should not be overturned on review unless it is shown that the district court abused its discretion. *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir. 1976).

Appellants have asserted that joinder of the limited partners is impracticable. Following denial of class status, however, Spectrum was able to reach all 92 limited partners, 56 of whom joined in the second lawsuit that was later consolidated with the original action. This indicates that joinder was not impracticable. Moreover, it may indicate that several potential members of the class did not wish to pursue their claims, despite the fact that it would cost them nothing.

Appellants also contend that all questions of law or fact in the case are common to the limited partners. There is evidence in the pleadings that the several intervenors relied on different communications when they decided to approve the exchange. Some of the representations made to them were by Spectrum, and there may have been reason for the trial judge to believe that the interests of these parties would be in conflict if the case went to trial. Although it appears that most of the issues are common to all potential

members of the class, the judge did not abuse his discretion in denying certification.[1]

We affirm in part, reverse in part, and remand the case to the district court for proceedings in accordance herewith.

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[1]HKF claims that because all 92 of Spectrum's limited partners received notice of the second lawsuit, and because 56 of them elected to join it, the class action question is moot now that the two cases have been consolidated. Thirty-six potential members of the class are not parties to the lawsuit. The issue is not moot unless all potential members of the class are parties.

Spectrum Financial Companies v. Marconsult, 'etc. Nos. 76-2546/2651.

Filed: Nov. 14, 1979.

FERGUSON, District Judge, concurring specially.

While I concur in the decision of the majority, I do not join in that section of the opinion which addresses the issue of duty to disclose. This case provides the circuit with an opportunity to clarify its position on the effect that *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), and *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978), had on our 1974 decision in *White v. Abrams,* 495 F.2d 72 (9th Cir. 1974).

In the three years since the Supreme Court decided *Hochfelder,* overruling the "flexible duty" negligence standard of *White v. Abrams* in favor of a form of scienter involving more than negligence, this circuit has addressed the question of *White v. Abrams*' continuing vitality several times—with varying results.

Initially, this circuit seemed to take the position that the Supreme Court had dealt a death blow to *White v. Abrams* in footnote 12 of *Hochfelder,* where the Court listed the decision as an example of the negligence standard it was repudiating. In *Robinson v. Heilman,* this court held that the scienter standard encompassed some of the factors from the duty analysis, but that there should not be a separate duty inquiry. *Robinson v. Heilman,* 562 F.2d 1304 (9th Cir. 1977). The court stated: "Of course, the closer the relationship of the person charged on the corporation and the greater his participation in the transactions attacked, the easier it will be to prove the requisite *scienter.* That state of affairs, however, provides no justification for any inference that direct participants have any

greater or different duty to buyers or sellers of securities than those whose connections with the transactions may be more remote." *Id.* at 1308.

Then, the circuit resurrected *White* in *Crocker Citizens National Bank v. Control Metals Corp.,* 566 F.2d 631 (9th Cir. 1977). The court held that "[a]bsent the possibility of liability based upon negligence, *Hochfelder* is not inconsistent, on its facts, with the flexible duty standard established in *White v. Abrams.*" *Id.* at 636 n. 2. The circuit reiterated the *Crocker* view in *Zweig v. Hearst,* 594 F.2d 1261, 1268 n. 13 (9th Cir. 1979), and again in *Kidwell ex rel. Penfold v. Meikle,* 597 F.2d 1273, 1294 (9th Cir. 1979); yet it took a different approach in *Ritzau v. Warm Springs West* and treated the standard as "rejected":

> The district court's reliance on the "flexible duty" standard of *White v. Abrams* was well placed at the time of decision, but the Supreme Court has since explicitly rejected that standard in *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 193, n. 12, 96 S. Ct. 1375, a rejection binding on us.

Ritzau v. Warm Springs West, 589 F.2d 1370, 1374 (9th Cir. 1979). In addition, when the circuit decided that recklessness satisfies Hochfelder's scienter requirements, it made no mention of a separate duty analysis. *Nelson v. Serwold, supra,* 576 F.2d 1332.

Two district courts in the Ninth Circuit have faced the *Hochfelder/White v. Abrams* issue. In the first case, which predated the opinions listed above, the court held that the flexible duty test and the scienter requirements of *Hochfelder* were each prerequisites to 10b-5 liability. *Carr v. New York Stock Exchange,*

414 F. Supp. 1292, 1300 (N.D. Cal. 1976). More recently, a district court observed that "[b]ecause [the] flexible duty standard permitted liability in certain circumstances based upon negligence alone, its precedential value is in question after *Hochfelder.*" *In re Gap Stores Securities Litigation,* 457 F. Supp. 1135, 1140-41 (N.D. Cal. 1978). After comparing *Crocker-Citizens National Bank v. Control Metals Corp., supra,* with *Robinson v. Heilman, supra,* the court concluded: "Until the Ninth Circuit explicitly re-examines *White v. Abrams,* however, it should be followed to the extent it is not directly inconsistent with *Hochfelder.*" *In re Gap Stores Securities Litigation, supra,* at 1141.

I believe that a re-examination of the flexible duty standard in light of *Hochfelder* shows that the time has come to lay *White v. Abrams* to rest. The five-factor duty analysis helps a court evaluate the foreseeability of harm to a plaintiff from the defendant's actions and the level of culpability of the defendant's conduct. These evaluations are relevant, and even necessary, to a finding of liability based on negligence. After *Hochfelder, supra,* and *Nelson v. Serwold, supra,* however, 10b-5 liability requires proof of recklessness, and the duty analysis is no longer appropriate.

This court has not defined recklessness in the context of securities violations,[1] but the Second and Seventh Circuits have described "[r]eckless conduct [as], at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious

[1]In *Nelson v. Serwold, supra,* 576 F.2d at 1337, we held only that "[t]he evidence supports a finding of recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate and cold-blooded.'"

that the defendant must have been aware of it.'"[2] *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 47 (2d Cir. 1978), *quoting Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977).

If this circuit adopts a similar definition of recklessness, the scienter requirements of *Hochfelder* and *Nelson* will be satisfied when a court concludes that a defendant's conduct was highly unreasonable and presented a known or highly obvious danger to the plaintiff. If the circuit should adopt a different definition, the scienter requirements will be satisfied when the test set forth in that definition is met. There is no reason to require the court then to engage in a complex, multi-faceted duty analysis which was designed to test negligence.

It may be useful at this point to consider a bit of the history of *White v. Abrams.* Before *Hochfelder* established that negligence could not be the basis for 10b-5 liability, the circuit courts wrestled for years with different state of mind requirements. When this circuit decided *White v. Abrams,* Professor Bromberg hailed the five-factor flexible duty standard as "an important break from traditional verbalisms, . . . promis[ing] emphasis on more significant aspects of cases." A. Bromberg, 4 Securities Law, Fraud § 8.4(500) (Supp. 1975).

The verbalisms from which *White* departed were those of common law fraud which had dominated 10b-5 law up to that time. The *White* court's departure

[2]The Second Circuit left open the question whether it would find 10b-5 liability when recklessness was determined under the less strict test established in *Stern v. American Bankshares Corp.,* 429 F. Supp. 818, 826 (E.D. Wis. 1977): "plaintiff must allege . . . that the defendants knew or should have known of the facts and circumstances concerning the fraud." *See Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d at 47 n. 16.

was based, in part, on *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 92 S. Ct. 1456 (1972), where the Supreme Court had held that causation was established without proof of reliance, where the defendants had a duty to disclose but nonetheless withheld material facts. *Id.* at 154, 92 S. Ct. 1472. This court saw *Ute* as disregarding common law fraud elements for an analysis of "what kind of a duty rule 10b-5 imposes." *White v. Abrams, supra,* 495 F.2d at 731. The court stated:

> Although the elements of common law fraud were important in defining what factors should be considered, they were neither limits nor barriers to the extent of the defendant's duty under the rule.
>
> The expressions of the court are not only meaningful, but chart the way for a proper analysis of 10b-5 liability. It is not based upon easily defined, well-known legal theories such as common law fraud, nor is it based upon convenient, differently interpreted, short hand latin phrases behind which one can sweep complex determinations. Rather, we are to examine the totality of the factual context and measure it by the duty imposed on the defendant.

Id. at 731-32.

Unfortunately, the duty standard in application sometimes does mask complex determinations. The five factors that the *White* court set out for consideration are:

> [1] the relationship of the defendant to the plaintiff, [2] the defendant's access to the information as compared to the plaintiff's access, [3] the benefit that the defendant derives from the relationship, [4] the defendant's awareness of whether the plaintiff was relying upon their relationship

> in making his investment decisions and [5] the defendant's activity in initiating the securities transaction in question.

Id. at 735-36 (footnotes omitted).

Not all factors are necessary to a finding of liability in a given case. *See, e.g., Kidwell ex rel. Penfold v. Meikle, supra,* 597 F.2d at 1296-97; *Zweig v. Hearst, supra,* 594 F.2d at 1269. Instead, a court applying the test must "[w]eigh[] all these facts in light of the principles of full disclosure that Rule 10b-5 was meant to foster." *Kidwell ex. rel. Penfold v. Meikle, supra,* 597 F.2d at 1297.

A court examining elements such as the relationship of defendant to plaintiff and plaintiff's and defendant's relative access to information must weigh many of the same elements that figure into the traditional concepts of materiality and causation.[3] For example, whether a statement could reasonably be expected to influence the decision to sell and was therefore material will be affected by the two factors just listed as well as by defendant's awareness of plaintiff's reliance. Factors (3) and (5), which go to the defendant's culpability, may not be subsumed as clearly within the common law standards, but the two considerations may figure somewhat in the scienter analysis. To the extent that they are not thus incorporated, the factors only serve to confuse the liability determination. There is nothing

---

[3]These concepts remain central to 10b-5 liability determinations. The Supreme Court framed the duty approach in *Ute* in terms of materiality and causation, *Affiliated Ute Citizens v. United States, supra,* 406 U.S. at 154; and the lower courts continue to require these elements. *See, e.g., Zweig v. Hearst Corp.,* 594 F.2d 1261, 1266 (9th Cir. 1979); *Nelson v. Serwold, supra,* 576 F.2d at 1335; *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 562 F.2d 1040, 1048 (8th Cir. 1977); *Valente v. Pepsico, Inc.,* 454 F. Supp. 1228, 1236 (D. Del. 1978).

in *Hochfelder* to suggest that a defendant who intentionally causes another to suffer damages through the purchase or sale of a security should be exonerated because he does not benefit financially from the relationship.

Application of the factors sometimes produces awkward results in other ways, as well. This case demonstrates the problem. Factor one looks to the relationship between defendant and plaintiff, properly contemplating a greater likelihood of liability where plaintiff and defendant are in a fiduciary relationship. *See Rolf v. Blyth, Eastman Dillon & Co., Inc., supra,* 570 F.2d at 44. There is no real relationship between plaintiff and defendant here, and there seldom would be one unless defendant were the buyer, seller or broker. Thus the court is confronted with the necessity of manufacturing the relationship from a tenuously defined benefit that the defendant receives from the transaction, as here, or dropping the requirement altogether, as it did in *Zweig v. Hearst Corp.,* 594 F.2d 1261, 1267 (9th Cir. 1979).

We may avoid this problem quite easily by recognizing that the flexible duty negligence standard is just that—a negligence standard. We have followed the Supreme Court's dictates in *Hochfelder* and required scienter instead of negligence. We should recognize that it is, therefore, no longer appropriate to apply a duty standard that was designed to compartmentalize and simplify a negligence inquiry. As does the case before us, *Hochfelder* addressed the liability of an accounting firm for omissions made in connection with the sale of a security. The Supreme Court inquired into scienter and made no separate duty inquiry, and we should do the same.

/s/ Warren J. Ferguson
WARREN J. FERGUSON
United States District Judge

APPENDIX B.

MARCONSULT, INC.

Financial Statements.

FOR THE PERIOD SEPTEMBER 1, 1970 TO DECEMBER 31, 1971

HARRIS, KERR, FORSTER & COMPANY

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NOTES TO FINANCIAL STATEMENTS

HARRIS, KERR, FORSTER & COMPANY
Certified Public Accountants
727 West Seventh Street,
Los Angeles, California 90017
(Letterhead)

The Board of Directors and Stockholders of
Marconsult, Inc.

We have examined the balance sheet of Marconsult, Inc. at December 31, 1971 and the related statements of common stock and paid-in capital, loss and accumulated deficit, and changes in financial position for the period September 1, 1970 to December 31, 1971. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Certain investments of the Company and the capitalized development costs, which are further discussed in Notes 2 and 3, represent a significant portion of the total assets of the Company at December 31, 1971. Recovery of the investments and development costs is dependent upon the success of the Company, in obtaining future, as well as profitable, projects in these areas.

In our opinion, subject to the recovery of these costs as described in the preceding paragraph, such financial statements present fairly the financial position of Marconsult, Inc. at December 31, 1971 and the results of their operations for the period then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (Note 1).

/s/ Harris, Kerr, Forster & Company
Los Angeles, California
April 24, 1972

MARCONSULT, INC.
BALANCE SHEET
DECEMBER 31, 1971

EXHIBIT A

ASSETS		
CURRENT ASSETS		
Cash		$ 5,134
Accounts Receivable (Net of Allowance for Doubtful Accounts of $!5,483)		33,162
Prepaid Expenses		6,399
Total Current Assets		44,695
INVESTMENTS (At Cost) (Note 2)		42,556
DEVELOPMENT COSTS (Net of Amortization of 13,764) (Note 3)		100,318
PROPERTY AND EQUIPMENT (At Cost) (Note 4)		
Marine Equipment	$100,503	
Office Furniture and Equipment	17,047	
Lab Equipment	9,787	
Leasehold Improvements	3,499	
	130,836	
Less: Accumulated Depreciation	36,014	94,822
OTHER ASSETS		1,159
TOTAL ASSETS		$283,550

LIABILITIES AND STOCKHOLDERS' (DEFICIT)		
CURRENT LIABILITIES		
Notes Payable—Bank		$ 20,000
Notes and Contracts Payable—Other		63,817
Accounts Payable		112,900
Payroll Taxes Payable		21,683
Accrued Expenses		
Salaries		8,952
Interest		4,306
Advance Deposit on Contract		25,000
Total Current Liabilities		256,658
ADVANCES AND NOTES PAYABLE — OFFICERS (Note 5)		40,715
STOCKHOLDERS' (DEFICIT)		
Common Stock $.10 Par Value 2,000,000 Shares Authorized 724,554 Shares Issued and Outstanding (Exhibit B) (Note 6)	$ 72,455	
Paid-in Capital (Exhibit B)	260,119	
Accumulated (Deficit) (Exhibit C) (Note 1)	(346,397)	
Total Stockholders' (Deficit)		(13,823)
TOTAL LIABILITIES AND STOCKHOLDERS' (DEFICIT)		$283,550

See accompanying Notes to Financial Statements.

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EXHIBIT B

MARCONSULT, INC.

STATEMENT OF COMMON STOCK AND PAID-IN CAPITAL

DECEMBER 31, 1971

	Common Stock	Paid-In Capital
BALANCE—September 1, 1970	$65,000	$ 65,000
March 31, 1971—Exercise of Stock Options for 6,500 Shares at $1.92 (Note 6)	650	11,850
June 30, 1971—Purchase and Retirement of 19,000 Shares in Exchange for 19,000 Shares of International Oil and Gas, Ltd., Valued at $3,867 (Note 2)	(1,900)	(1,967)
June 30, 1971—Cancellation of Contingent Stock Options for 69,149 Shares in Exchange for 20,000 Shares of International Oil and Gas, Ltd., Valued at $4,069 (Note 2)		(4,069)
October 31, 1971—Net Proceeds from Public Sale of 87,054 Shares of Common Stock	8,705	189,305
BALANCE—DECEMBER 31, 1971	$72,455	$260,119

See accompanying Notes to Financial Statements.

EXHIBIT C

MARCONSULT, INC.

STATEMENT OF LOSS AND ACCUMULATED (DEFICIT)
FOR THE PERIOD SEPTEMBER 1, 1970 TO
DECEMBER 31, 1971

INCOME	
Consulting Fees	$ 351,402
Other	471
Total Income	351,873
EXPENSES	
Specific Job Costs	175,051
Salaries	317,849
Rent	14,500
Interest	15,886
Depreciation and Amortization (Note 4)	28,446
Amortization—Development Costs (Note 3)	13,764
Other Expenses	104,390
Total	669,886
Less: Capitalized Development Costs (Note 3)	120,342
Total Expenses	549,544
NET LOSS BEFORE EXTRAORDINARY ITEM	(197,671)
Loss on Investment (Note 8)	25,000
Abandoned Projects (Note 8)	50,273
Total Extraordinary Items	75,273
NET LOSS	(272,944)
ACCUMULATED (DEFICIT) — Beginning of Period (Note 1)	(73,453)
ACCUMULATED (DEFICIT) — End of Period (Exhibit B)	$(346,397)
Loss Per Common Share (Note 7)	
Net Loss Before Extraordinary Item	$ (.29)
Extraordinary Item	(.12)
Net Loss	$ (.41)

See accompanying Notes to Financial Statements.

EXHIBIT D

MARCONSULT, INC.

STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE PERIOD SEPTEMBER 1, 1970 TO
DECEMBER 31, 1971

FUNDS PROVIDED	
Proceeds from Sale of Equipment	$ 15,510
Proceeds from Officers Loans	18,500
Proceeds from Sale of Common Stock	198,009
Conversion of Notes Payable for Common Stock (Note 6)	12,500
Total Funds Provided	244,519
FUNDS APPLIED	
Operations	
Net Loss for the Year Before Extraordinary Item	(197,671)
Expenses not Requiring Cash Outlay	
Depreciation	28,446
Amortization	13,764
Officers Salaries	23,958
Other	5,606
Capitalized Costs (Note 3)	(120,342)
Funds Applied to Operations	246,239
Purchase of Property and Equipment	72,695
Decrease in Long-Term Debt	24,183
Payments on Officers Loans	12,724
Other	170
Total Funds Applied	356,011
DECREASE IN WORKING CAPITAL	$(111,492)
CHANGES IN WORKING CAPITAL	
Increase (Decrease) in Current Assets	
Cash	$ (13,867)
Accounts Receivable	(145,950)
Prepaid Expenses	(5,020)
(Increase) Decrease in Current Liabilities	
Notes and Contracts Payable	34,761
Accounts Payable	45,245
Payroll Taxes and Accrued Expenses	(4,161)
Advance Deposit on Contract	(22,500)
DECREASE IN WORKING CAPITAL	$(111,492)

See accompanying Notes to Financial Statements.

MARCONSULT, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1971

NOTE 1—CHANGE IN ACCOUNTING PERIOD

The Company elected to change its reporting period from an August 31 to December 31 year end. Accordingly, the statement of income and accumulated deficit reflects the operations from September 1, 1970 to December 31, 1971. The gross revenue and net loss for the four months ended December 31, 1970 amounted to $294,529 and $(27,340) respectively.

NOTE 2—INVESTMENTS

Investments consist of the following:

	Cost
50,176,714 shares of Fortuna Offshore Mining & Exploration Corporation under a subscription agreement. Fortuna is engaged in both onshore and offshore mineral and oil resource development activities. This is a Philippine corporation with 8,120,000 shares of stock issued and outstanding, and 1,290,536,712 shares under subscription obligations at December 31, 1970; the shares owned by the Company are included in the total shares under subscription. The stock is presently traded in the over-the-counter markets in the Philippines at approximately 0.013 Pesos per share or a total value of about $100,354. However, the Company has been informed that trading in the stock is on a very limited basis and there is no assurance that the Company could readily convert its entire investment into U.S. dollars during any short period of time. In addition, if the Company chose to liquidate its investment it would first have to retire its subscription obligation totalling 376,325 Pesos which has a U.S. dollar equivalent value at this date of approximately $59,000.	$32,165
51,000 shares of preferred stock of International Oil and Gas, Ltd. On June 17, 1971, the Corporation exchanged its investment in 490 shares of Greenland Exploration Management Company (GEMCO) Incorporated for 90,000 shares of preferred stock of International Oil and Gas, Ltd. (a Tennessee Corporation) and a $50,000 note, due February 1, 1972, or sooner, upon certain events.	$10,391

The stock has been valued at the same cost basis as the shares of GEMCO which were exchanged. The Company has granted a six month extension on the maturity of the note receivable. The Company has not reflected the note receivable in its financial statements because of the uncertainty of collection which is contingent upon the sale of stock for cash by International Oil and Gas, Ltd. of not less than $1,000,000.

The note receivable is secured by an agreement to convey to the Company up to a maximum of 20% of International's interest in GEMCO, subject, however, to the obligation of International to first offer said interest to the other party to the GEMCO joint venture at a price equal to the unpaid indebtedness.

Concurrently with the exchange of shares of GEMCO, the Company entered into a series of agreements wherein 39,000 shares of International that the Company received were transferred to Mr. Gustavson (former president of Marconsult, Inc.) in exchange for the cancellation of his contingent option to acquire 69,149 shares of common stock and the surrender for cancellation of 19,000 shares of common stock of the Company then owned by Mr. Gustavson. The cost of reacquiring the shares and stock option was based on a proration of the original cost of the GEMCO shares as explained previously. The costs relating to these transactions have been charged against common stock and paid-in capital.

NOTE 3—DEVELOPMENT COSTS

The Company has adopted the policy to defer costs relating to projects in the developmental or proposal stage. In addition the Company has deferred certain costs over and above those funded on previous projects. The Company anticipates future sales and profits will be derived from its investments in the projects.

For the four months ended December 31, 1970, the Company deferred costs of approximately $11,500 relating to the projects under development and charged to operations during the same period approximately $50,000 of previously deferred project costs. During the year ended December 31, 1971, the Company deferred costs of approximately $77,900 relating to the same projects.

The Company also established the policy of amortizing these costs over an estimated life of generally 5 to 7 years. Such

NOTE 3—DEVELOPMENT COSTS—Continued

costs amortized for the year ended December 31, 1971 and the four months ended December 31, 1970 amounted to $12,167 and $1,597 respectively.

The Company also develops, builds and/or modifies certain equipment which it considers necessary for its operations. Costs capitalized for the year ended December 31, 1971 amounted to approximately $22,000; costs capitalized in prior periods amounted to approximately $9,000.

NOTE 4—PROPERTY AND EQUIPMENT

Depreciation has been computed on a straight-line basis for both accounting and tax reporting at annual rates averaging 33-1/3 percent for Marine Equipment, 10 percent to 20 percent for Laboratory Equipment, 12-1/2 to 33 percent for Office Furniture and Equipment and 20 percent for Leasehold Improvements.

NOTE 5—ADVANCES AND NOTES PAYABLE—OFFICERS

The advances and notes payable consists of advances of approximately $35,000 for accrued salaries and $5,700 of non-interest bearing loans at December 31, 1971.

NOTE 6—STOCK OPTIONS AND WARRANTS

In September, 1970, the Board of Directors authorized a Qualified Stock Option Plan, approved by the shareholders in November, 1970, whereby 80,000 shares of the Company's common stock were reserved for issuance to key employees of the Company.

Certain key employees held options under the Company's qualified stock option plan to purchase an aggregate of 14,300 shares of common stock at December 31, 1971. The option prices range from $.48 to $3.00 per share and expire five years after date of grant in 1975 and 1976.

An option to purchase not to exceed 52,700 shares of common stock at $.20 per share exercisable on or before February 14, 1975, remains outstanding to a note holder who advanced monies to the Company in 1968.

At the time of the initial public sale of the Company's common stock in October, 1971, the Company sold warrants to its securities marketing company; the warrants consist of the right to purchase 8,000 shares of common stock at exercises prices ranging from $3.00 to $3.63 per share and expires in October 1976.

During the year ended December 31, 1971, options for 6,500 shares were exercised in exchange for payments of Notes Payable totaling $12,500. In addition, options to purchase shares totaling 5,850 and 69,149 shares (see Note 2) were either cancelled and/or repurchased respectively.

NOTE 7—LOSS PER SHARE

Loss per common share for the period has been computed based on the actual shares outstanding for the four months ended December 31, 1970 and on the weighted average of shares outstanding during the year ended December 31, 1971 which totaled 659,879. Options and warrants have not been recognized in their computations as the affect in loss per share would have been anti-dilutive.

NOTE 8—EXTRAORDINARY ITEM

In 1971, the Company determined that the investment in Offshore Minerals Corporation, Inc. had no value and as a result has provided for the loss of investment of $27,000 less a liability due to the Company by Marconsult, Inc. of $2,000.

In 1970, the Company ceased work in certain developmental projects and has expensed such costs totalling $50,373 as abandoned projects.

NOTE 9—INCOME TAXES

The Company has available net operating loss carryforwards totalling approximately $103,000 which expire from 1973 to 1976.

NOTE 10—SUBSEQUENT EVENTS

Effective January 1, 1972, the Company entered into an agreement to acquire the outstanding stock of Cannon Diamond Drilling Company, Ltd. in exchange for 40,000 shares of common stock of Marconsult, Inc. for an assigned value of $320,000. The unaudited book value of the company at January 1, 1972 approximates $325,000.

Also effective January 1, 1972, the company entered into an agreement to purchase certain assets (consisting of 16 gas and one oil well) of an oil and gas limited partnership venture in exchange for 145,000 shares of common stock of Marconsult, Inc. for an assigned value of $550,000, plus a convertible note payable in the amount of $250,000. In addition, the company assumed a mortgage liability of approximately $193,000. The agreement has not been finalized as the company requested a hearing before the California Commissioner of Corporations which is presently pending.

Supreme Court, U. S.
FILED
MAR 12 1980
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1979
No. 79-1251

HARRIS, KERR, FORSTER AND COMPANY,

Petitioner,

vs.

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

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October Term, 1979
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HARRIS, KERR, FORSTER AND COMPANY,

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vs.

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Questions Presented.

1. Respondent takes exception to Petitioner's characterization of the nature of the legal issues sought to be reviewed. The facts in this action are such that the trier of fact might properly find that HKF was not only "reckless," but also acted with full knowledge of the impropriety of its conduct.

2. Respondent also takes exception to Petitioner's characterization of the opinion of the Ninth Circuit Court of Appeals in the instant case as a decision which construed the standard of "recklessness" in a manner such as to sanction liability for "merely negligent conduct." It is submitted that after *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Ninth Circuit has consistently held that negligence is not sufficient to establish liability in a 10b-5 action.

3. Finally, Respondent takes exception to Petitioner's conclusion that the Ninth Circuit's "flexible duty" approach, as set forth in *White v. Abrams,* has been applied in the instant case as either a substitute or alternative for the scienter requirement. It is submitted that the Ninth Circuit is not using the "flexible duty" approach as a substitute or an alternative for the scienter requirement established by *Hochfelder.*

Statement of the Case.

Respondent feels constrained to comment upon Petitioner's version of the "facts" in the case at bar, particularly in light of the fact that this case comes to this Court as a result of a reversal of the trial court's granting of summary judgment in favor of Petitioner.

Petitioner's brief states that Marconsult, Inc. (hereinafter "Marconsult"), around whose fortunes the case turns, "was consistently cash-poor and did not prosper." (Petition, page 3). At best, this may be viewed as an understatement. Marconsult was, for all practical purposes, completely defunct (CT 1008-1020).

The Petitioner's brief also asserts that the exchange of Respondent's oil and gas interests for Marconsult's securities was approved by the limited partners in Spectrum Leveraged Natural Gas I and II (hereinafter "SLNG I and II"), without reliance on the sixteen-month report prepared by the Petitioners (Petition, page 7). This ignores the fact that the transaction was expressly conditioned upon the approval of the California Commissioner of Corporations (CT 953, lines 23-26). Thus, the partners of SLNG I and II relied upon the expertise of the California Commissioner of Corporations, who in turn relied upon the sixteen-month statement prepared by HKF (CT 1074).

The Petitioner's brief also asserts that the limited partners in SLNG I and II were "high-income individuals" who invested in the partnership for the "primary purpose of obtaining tax shelter." There are no facts of record to support such statements, and they are entirely irrelevant to the issues herein.

The Petitioner also states that its second motion for summary judgment was granted because "the complaint raised no triable issue of fact regarding scienter as required by *Hochfelder* . . ." (Petition, page 9). Inasmuch as the district court granted the motion without opinion, it is submitted that Petitioner has overstepped its bounds by supplying the district court with such purported grounds.

Rather than further comparing at length the "facts" presented by Petitioner with those established by Respondent in its opposition to Petitioner's motion for summary judgment, Respondents submit that the following are, in reality, the genuine "material facts" which created the "genuine issues" for purposes of the summary judgment motion decided by the trial court in the instant case.

The salient facts, as they pertain to the substantive issues, disclose that in early January of 1972, the general partner of two limited partnerships, SLNG I and II entered into an agreement with Marconsult, Inc. (Pretrial Conference Order, section III, "Admitted Facts" CT 953), pursuant to which the limited partners of the limited partnerships agreed to exchange their respective limited partnership interests in certain producing oil and gas wells for common stock and debentures by Marconsult, Inc. (CT 953, lines 10-14). This agreement was conditioned upon the approval of at least

75% of the limited partner of each partnership and the approval of the California Commissioner of Corporations (CT 953, lines 23-26).

In March, 1972, HKF was hired by Marconsult to conduct an audit of Marconsult's financial condition for the calendar year 1971 (CT 953, lines 27-31). During the course of this audit HKF gained the knowledge of the pending exchange and the pending hearing before the California Commission of Corporations (CT 1004, lines 4-11) and knew that the financial condition of Marconsult was a substantial and important factor that would be considered by both the limited partners and the California Commissioner of Corporations in determining whether the exchange would go forward (CT 1005, line 22 through CT 1006, line 3; CT 1007, lines 5-14).

On May 8, 1972, HKF delivered to Marconsult draft copies of Marconsult's financial statements for the calendar year 1971 (the "twelve month statement") together with its audit report dated April 24, 1972, in which HKF stated that the financial statements had been prepared in accordance with generally accepted accounting principles, consistently applied (CT 1036, 1038) subject only to certain qualifications with reference to certain research and development items and foreign investments which HKF could not verify (CT 1038, 1044).

This twelve month financial statement disclosed that Marconsult had only approximately $57,000.00 in sales during the entire calendar year 1971 (CT 1042) and had suffered a loss of approximately $245,604.00 during that calendar year (CT 1042). Marconsult concealed the existence of the twelve-month financial statement and rather than distributing it to the general

and limited partners or filing it with the California Commissioner in support of its application of permit for approval of the proposed exchange, requested HKF to certify new financial statements covering a sixteen-month period from August 31, 1970 to December 31, 1979 (CT 954, lines 19-22 [Pretrial Order—Section 3 "Admitted Facts," para. 13]).

In response to this request, HKF prepared the sixteen-month statement, to which it attached a certification substantially identical to the certification which it previously prepared in connection with the twelve-month statement (CT 1056-1058).

This sixteen-month statement was delivered by HKF to Marconsult between July 5, 1972 and July 14, 1972 (CT 1073) and was then delivered by Marconsult to both the general and limited partners of the limited partnerships (CT 772-773) and was filed with the California Commissioner of Corporations in support of Marconsult's application to issue freely tradeable common stock and debentures to the limited partners in exchange for the limited partnerships' interest in the oil and gas wells (CT 1074). The sixteen-month statement totally distorted the true financial condition of Marconsult and was not useful for any purpose other than as a attempt to confuse the reader as to Marconsult's financial condition (CT 1068). Among other things, this financial statement incorporated more than $200,000.00 of business conducted by Marconsult during the four-month "stub period" (CT 791) which was not included in the previously prepared twelve-month financial statement (CT 1042) (The four-month "stub period" incorporated in the sixteen-month statement was a period prior to the period covered by the twelve-month statement).

During the course of the audit HKF discovered that Marconsult was insolvent; had a negative net worth (CT 1012, lines 2-12); had consistently lost money (CT 1008); was unable to pay its bills or the salaries of its employees (CT 1015, 1020) and had effectively gone out of business.

Respondents contend that HKF misrepresented the true financial condition of Marconsult by stating, in the audit report which accompanied Marconsult's sixteen-month statement, that the financial statements had been prepared in accordance with generally accepted accounting principles, consistently applied, and by failing to prominently and unequivocally state in its audit letter that it could not render an opinion with respect to the company's financial statements because Marconsult was not a going business concern, was hopelessly insolvent and was in imminent danger of collapse.

Respondents further contend that HKF, in its opinion letter, omitted the material fact that the sixteen-month financial statement was not, by its very nature, prepared in accordance with generally accepted accounting principles, consistently applied, and in its certification failed to advise the reader that Marconsult was not a going business concern, and was, in effect, defunct.

HKF delivered Marconsult's sixteen-month financial statement, with the accompanying audit report, to Marconsult sometime between July 6, 1972 and July 14, 1972 (CT 772).

Sometime between July 6, 1972 and July 14, 1972, Marconsult mailed the sixteen-month financial statement and HKF's audit report thereon, to Spectrum's Limited Partners (CT 1067-1069). The twelve-month financial

statement with the audit report by HKF affixed thereto, was never distributed to Spectrum, the Department of Corporations, or Spectrum's Limited Partners.

On July 20, 1972, Marconsult filed an "Application for Removal of Condition on Shares of Common Stock" with the California Department of Corporations. This application was required in order to fulfill the condition precedent to the Marconsult/Spectrum exchange that Spectrum's Limited Partners were to receive freely tradeable stock (CT 1034). On August 17, 1972, after receiving HKF's opinion with respect to the sixteen-month financial statement of Marconsult, the California Department of Corporations removed the condition previously imposed by it upon the free tradeability of Marconsult stock to be received by Spectrum's Limited Partners (CT 1007).

REASONS FOR DENYING THE WRIT.

I

ALL OF THE COURTS OF APPEAL ARE IN AGREEMENT ON THE INTERPRETATION OF ERNST & ERNST v. HOCHFELDER.

A. There Is No Conflict Among the Courts of Appeal.

Petitioner has made the sweeping statement that "the eye of the needle in *Hochfelder's* footnote 12 now readily accommodates camels of all sizes, so long as they are labeled 'recklessness' " (Petition, page 12). This lyrical assertion is then "supported" by lengthy citations which Petitioner suggests distort the holding of *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). However, a closer reading of the cited cases discloses that they have each carefully followed *Hochfelder* and have required a finding of "recklessness" to establish *10b-5* liability.

In *Sundstrand v. Sun Chemical Corp.,* 553 F.2d 1033, 1044 (7th Cir. 1977), *cert. denied,* 434 U.S. 875 (1977), the court held that "A reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under Section 10(b) as fleshed out by rule 10b-5." The Seventh Circuit has defined "recklessness" by reference to the definition in *Franke v. Mid-Western Oklahoma Development Authority,* 428 F.Supp. 719 (W.D. Okla. 1976), as "the functional equivalent of intent." 553 F.2d at 1045. This definition was further clarified in *Sanders v. John Nuveen & Co., Inc.,* 554 F.2d 790, 793 (7th Cir. 1977), in which the court held, "We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind." Certainly this definition falls within *Hochfelder's* scope of scienter since it is expressly closer to intent than it is to negligence.

In *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978), the Fifth Circuit ruled in a manner consistent with *Hochfelder,* and held that the defendant must "know of the falsity of the information, or must act in reckless disregard of its falsity, or must intend to deceive." This definition is squarely in line with the *Hochfelder* requirement of "knowing or intentional misconduct." 425 U.S. 185, 197 (1976).

The Third Circuit, in *Coleco Industries, Inc. v. Berman,* 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied,* 439 U.S. 830 (1978), defined scienter in 10b-5 actions as a conscious deception or a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception. This definition also clearly squares with *Hochfelder.*

Petitioner has characterized *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d 38 (2d Cir. 1978) *cert. denied,* 439 U.S. 1039 (1978) as a " 'sliding scale' approach to scienter" (Petition, page 12, n. 7), because the case limits its acceptance of recklessness only to some situations. *Rolf* involved an aider/abettor situation where the aider/abettor owed a fiduciary duty to the defrauded party. Rather than being a loose "sliding scale" test of liability as Petitioner suggests, *Rolf* involves a strict definition of recklessness as scienter in some circumstances. This is completely in accord with footnote 12 in *Hochfelder,* 425 U.S. at 193-194, n. 12. Furthermore, *Rolf* analyzed the *Hochfelder*

decision at length before accepting reckless conduct as scienter. Clearly, this is an attempt to comply with *Hochfelder* to the letter, rather than an attempt to vitiate it. *Rolf* at 44-47.

Petitioner would have this court believe that in *Mansbach v. Prescott, Ball and Turben*, 598 F.2d 1017 (6th Cir. 1979), the Sixth Circuit has gone so far as to expressly limit *Hochfelder* (Petition, page 13, n. 8). The portion of the opinion quoted by Petitioner is taken out of context. After observing that a rule 10b-5 action is to be liberally construed to effectuate the policies of the Federal Securities Laws, the Sixth Circuit states:

> In line with that rule of construction, we should construe the §10/Rule 10b-5 claim no more narrowly than required by *Hochfelder*.[32] Requiring a plaintiff to show that defendant acted with actual subjective intent to defraud could impose a great burden upon recovery, greatly limiting the §10b/Rule 10b-5 claim. We believe that *Hochfelder* should be read to go no further than its specific holding that mere negligence is not enough for liability.

Id. at 1024-1025. Footnote 32 explains "the narrowing construction in *Hochfelder* was not adopted as a policy matter but was seen as mandated by the relevant statutory language. 425 U.S. at 214, 96 S.Ct. 1375."

Moreover, rather than refraining from defining recklessness as Petitioner claims, (Petition, page 14, n. 9), *Mansbach* affirmatively adopts the Seventh Circuit definition, 598 F.2d at 1025.

Hoffman v. Estabrook & Co., Inc., 587 F.2d 509, 516 (1st Cir. 1978), is also misunderstood by Petitioner. Rather than defining recklessness as "carelessness approaching indifference" as Petitioner asserts (Petition, page 14) the First Circuit expressly refrains from deciding whether recklessness, as well as fraud, will ground an action under rule 10b-5. *Id.* Petitioner's quoted language is that of the district court. The court of appeals by-passed the district court's definition as unimportant since the evidence did not establish reckless conduct in any event. Moreover, the appellate court reaffirmed its definition of recklessness as laid down in *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978), that "[Reckless conduct] comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence." *Id.* This definition is identical to the one used in the Sixth and Seventh Circuits.

In criticizing *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir. 1978), *cert. denied*, 439 U.S. 970 (1978), the Petitioner has maligned the opinion unfairly. Rather than rashly broadening the scope of permissible 10b-5 actions as limited by *Hochfelder*, the Ninth Circuit undertook a scholarly judicial examination of that case. The opinion notes that Justice Powell accepted knowledge as well as intent by proscribing "knowing or intended misconduct," and further held that this Court strongly disagreed with the Securities and Exchange Commission argument that "Congress must have intended to bar all such practices and not just those done *knowingly* or intentionally" in making its decision. *Id.* 1337 (emphasis in original).

The *Nelson* court observed that *Hochfelder* cited no case or commentary indicating a requirement of strict common law intent. Further, the *Nelson* court reviewed the decisions of other circuits and, after determining that several had accepted recklessness as the

equivalent of scienter, decided to follow that path. *Id.* 1337.

Lastly, a brief word must be said about Petitioner's statement that the various circuits have "either refrained from defining 'recklessness' . . . or done so in either impossibly vague terms or terms which bear strong resemblance to ordinary negligence" (Petition, page 14, n. 9). To the contrary, the circuits have at times gone to great lengths to define "recklessness." ***See, e.g., Hoffman v. Estabrook & Co., Inc.***, 587 F.2d at 516.

Although Petitioner has attempted to argue that recent decisions of the circuit courts have eroded *Hochfelder*, it is clear that such is not the case. Moreover, since all of the circuits which have decided the issue are in accord regarding the interpretation of the rule 10b-5 scienter requirement, there is no need for this Court to grant certiorari. U.S. Sup. Ct. Rule 19(1)(b), 28 U.S.C.

B. The Interpretation of the Scienter Requirement by the Circuit Courts Is Correct and Proper.

As outlined in subpart A above, all of the circuit courts which have decided the issue are in agreement that the scienter requirement of *Hochfelder* is satisfied by proof of reckless conduct. These Respondents respectfully submit that the interpretation of the circuit courts is a correct and proper one under *Hochfelder*.

Neither the drafters of the Securities Exchange Act of 1934 nor this Court in *Hochfelder* intended to impose a more stringent standard for "scienter" than that imposed by the common law. It is clear that the 1934 Act was intended to provide more liberal remedies than permitted under the common law.

Historically, common law principles of deceit have their origin in *Derry v. Peek*, 14 A. 337 (1889). There the court dealt with liability for misrepresentation contained in a stock prospectus. The court held that while negligence was an insufficient basis for the imposition of common law liability for deceit, one who made a false statement while conscious that he had no sufficient basis to justify it or one who spoke with reckless disregard for the truth was liable in fraud. *See,* W. Prosser, *Torts* (4th Ed. 1971) at 700-701.

The issue of common law liability of an accountant who prepared a misleading financial statement was specifically considered in *Ultramares v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). Mr. Justice Cardozo rejected negligence as a basis of liability, but recognized an important distinction between "innocent misrepresentation" and "willful reckless misrepresentation." *Id.*

Later courts reasoned that if reckless disregard for the truth was deemed culpable behavior in common law, logic dictated that the Federal Securities Laws were intended to embrace recklessness as well. *See, Trussell v. United Underwriters, Ltd.,* (D.C. Colo.) 228 F.Supp. 757, 772 (1964).

The issue of scienter in the area of misrepresentation is also discussed by Prosser:

> The intent which becomes important is the intent to deceive, to mislead, to convey a false impression. Obviously this intent, which has been given the name of 'scienter' by the courts, must be a matter of belief, that the representation is true; . . .
>
> There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false.

> Likewise there is general agreement that it is present when the representation is made without any belief as to its truth, *or with reckless disregard whether it be true or false.*

W. Prosser, *Torts* (4th Ed. 1971) at 700-701 (emphasis added).

Since the gravamen of both the tort of misrepresentation and the rule 10b-5 action lie in the intent to deceive, the above discussion is equally applicable in both areas.

Applying the common law and the position taken by Prosser to *Hochfelder* leads one to the conclusion that scienter must include reckless conduct. *Hochfelder* gives no sign that this Court meant to be more restrictive than the common law in defining scienter. Given the fact that the district courts were permitting recklessness to be used as a standard prior to *Hochfelder,* this Court must have recognized that recklessness would continue to be used as a standard. Thus, this Court has implicitly paved the way for the current "recklessness" standard used by the various circuits.

II

THE DECISION DOES NOT RESURRECT THE NEGLIGENCE STANDARD.

Petitioner has argued that the decision below resurrects the "negligence" standard (Petition, page 18). Petitioner argues that the Ninth Circuit has resurrected *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974), and the "flexible duty negligence standard" as discussed in that case. This argument is without merit. The appellate court's discussion of *White v. Abrams* is fully consistent with this Court's holding in *Hochfelder. See, Spectrum Financial Companies v. Marconsult, Inc.,* 608 F.2d 377 (9th Cir. 1979).

The Ninth Circuit Court of Appeals noted that the district court granted the motion for summary judgment without benefit of its decision in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir. 1978), in which the Ninth Circuit adopted reckless behavior as sufficient for the scienter requirement. *Spectrum,* at 381. The court also noted that the district court judge did not indicate whether he examined the pleadings and depositions in light of a "recklessness" standard or required a stricter showing of intent and the court remanded for re-examination in light of *Nelson v. Serwold. Id.*

Only after thus deciding the case did the lower court begin any discussion of *White v. Abrams.* Clearly, that discussion was not the basis of the decision. Rather, the examination of whether Petitioner owed a duty to Respondent under *White v. Abrams* must be viewed as dictum, and did not impinge upon the criteria established in *Hochfelder.*

Petitioner has attempted to characterize the Ninth Circuit's decision in the instant case by labeling the duty requirement as "a substitute or alternative for scienter." (Petition, page 19). To the contrary, the lower court explained that the "duty to disclose" described in *White v. Abrams* presented an issue "*beyond* the issue of whether or not appellees were 'reckless' " (emphasis added) 608 F.2d at 381. Rather than diminishing the *Hochfelder* scienter requirement the lower court's decision has enlarged it by requiring not only a showing of reckless conduct, but an additional showing of duty. The burden upon plaintiffs in establishing 10b-5 liability is more strict, not less.

The lower court's decision does not need to be disturbed. Its discussion of *White v. Abrams* is merely dictum, and even if not, it strengthens, rather than weakens the *Hochfelder* scienter requirement.

III

THE INSTANT CASE IS NOT RIPE FOR REVIEW.

Petitioner has argued that even if "recklessness" suffices for scienter under rule 10b-5, nevertheless under no definition of recklessness could it be held liable (Petition, pages 14-17). We note that the Ninth Circuit reversed the order granting summary judgment, and remanded the instant action to the district court for consideration in light of *Nelson v. Serwold*. Furthermore, the rulings by the district court on Petitioner's motion for summary judgment were without opinion; Petitioner's assertion that the district court "found" that Respondents had failed to show that Petitioner had intended to deceive, manipulate or defraud, and that the district court "determined" that the action "could not proceed for lack of the element of scienter" (Petition, pages 14-15), are pure speculations and must be ignored. No such finding has been made. The case is now ready for the trier of fact to decide whether Petitioner was guilty of intentional misconduct, reckless misconduct, or merely negligent conduct.

Petitioner would have this Court decide at this time that a finding of either intent or recklessness is not possible. Certain "facts" have been asserted by Petitioner. Other opposing facts are, and have consistently been asserted by Respondent, which "facts" if proven may establish actual intent to defraud. Such factual determinations are for the trier of fact, not the appellate court. This case has been remanded to the district court in order that such factual determinations can be made.

Ripeness is basically a matter of timing. *See, Blanchette v. Connecticut General Insurance Corps.*, 419 U.S. 102 (1974). At the present time, this litigation does not present this Court with the concrete facts

that are necessary to an informed decision. When this case comes to trial, the trier of fact may very well find that Petitioner was guilty of intentional misconduct, in which case the question of recklessness would be moot. Conversely, the trier of fact may find Petitioner merely to be negligent, thus not liable, and again the recklessness issue would be rendered moot. Given these possibilities, this Court should not at this time undertake a review of this action. The Petition should be denied.

Conclusion.

Petitioner's petition for a writ of certiorari in the instant case should be denied. Petitioner has failed to show any grounds under the guidelines of Supreme Court Rule 19 upon which certiorari is appropriate. Various circuit courts, including the Ninth Circuit in this action, have addressed the issue of whether or not "recklessness" is sufficient to meet the "scienter" requirement in 10b-5 actions. All of these courts have concluded that "recklessness" is sufficient to state a cause of action under rule 10b-5. This result is entirely consistent with this Court's ruling in *Hochfelder*.

Additionally, this case is not yet ripe for review. The appellate court has ordered this action remanded to the district court for further findings of fact regarding the issue of "scienter." Therefore, Respondents respectfully submit that the petition for writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1979
No. 79-1251

HARRIS, KERR, FORSTER AND COMPANY,

Petitioner,

vs.

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Petitioner's Reply Brief in Support of Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Petitioner's Reply Brief in Support of Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner Harris, Kerr, Forster and Company respectfully submits this Brief in reply to Respondent's Opposition to Petition for Writ of Certiorari to the Ninth Circuit Court of Appeals. The primary purpose of this Brief is to direct the Court's attention to the recent opinion in *The Pegasus Fund, Inc. v. Laraneta,* ..... F.2d ..... (9th Circuit No. 77-3450, filed Feb. 14, 1980) which illustrates and supports each of the arguments advanced in support of petition for certiorari.[1]

[1]A true and correct copy of the opinion in the case appears as Appendix A hereto.

Statement of the Case.

The facts of the case, its legal posture, and the necessary determinations of the District Court in passing on the motion for summary judgment are accurately set forth in the petition and opinion of the Court of Appeals.

The case is ripe for review. It arises in precisely the same posture as *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) itself.[2]

[2]Respondents' contention that this case is not ripe for review (Opposition, pp. 16-17) misses the point. While factual determinations are for the trier of fact, Petitioner should not be forced to go to trial or even back to the District Court when the District Court has already ruled on the strength of *Hochfelder* that the requisite element of scienter for §10(b) and Rule 10b-5 liability is absent from the case. No trier of fact can properly be invited to find liability on a basis inconsistent with *Hochfelder*.

LEGAL DISCUSSION.

The Recklessness/Flexible Duty Test Has No Consistent Meaning Even Within the Ninth Circuit. Recklessness/Flexible Duty Cannot Be Consistently Applied in Conformity With Hochfelder.

Respondents' tortuous exegesis of the fate of the §10(b) and Rule 10b-5 scienter requirement enunciated in *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185 is wide of the mark.[3] In the cases cited by Respondents, the courts for the most part have paid nominal deference to *Hochfelder* while at the same time adopting recklessness standards which are in principle fundamentally inconsistent with *Hochfelder's* definition of scienter as intent to deceive, manipulate, or defraud. Even the most avid advocate of more expansive §10(b) liability must blush at the patent scholasticism of such questions as whether recklessness "comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence." (*Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790, 793 (7th Cir. 1977).)

The futility of Respondents' effort to find consistency in the recklessness approach is forcefully demonstrated by comparing *The Pegasus Fund, Inc. v. Laraneta, supra,* ..... F.2d ..... with the decision in the instant case. As we explain below, on facts remarkably similar to the present case, a different panel of the Ninth Circuit Court of Appeals reached a diametrically opposite result. The present case and *The Pegasus Fund* considered together illustrate clearly how the reckless-

[3]The same is true of Respondents' discussion of scienter in common law fraud actions. If §10(b) were no different from common law fraud it would be superfluous. Moreover, Respondents simply ignore the actual language of §10(b).

ness/flexible duty approach, like equity, varies with the length of the judge's foot.

In *The Pegasus Fund* the accounting firm of Arthur Young & Company was charged with failing in its audit of various mutual funds to discover facts indicating certain of the funds' assets were of doubtful value. These assets were (i) restricted debentures of Burreson & Co. secured by deeds of trust on realty which exceeded the face value of the debentures, and (ii) a restricted debenture and convertible preferred stock of Oh Boy! Industries, Inc. Arthur Young's audit failed to reveal that the Burreson & Co. debenture collateral was not first deeds of trust but all-inclusive deeds of trust allegedly representing junior security interests. Although Arthur Young had inspected the restricted securities, it merely accepted the statement of the custodian of the mutual funds' assets that the related collateral documents were first deeds of trust.

Furthermore, it was alleged:

> "Arthur Young's work papers for the audit disclosed that Burreson & Co. had an accumulated net worth deficit of over six million dollars and was delinquent in interest and principal payments on certain trust deed notes in the amount of $370,000 as of April 30, 1973. These notes were secured by the same realty that secured the plaintiffs' debentures, and represented a superior claim to that collateral. The work papers reflect that Burreson had been and was still running at a loss as of the date of the audit opinion. Financial statements included in the work papers revealed that Burreson had been a party charged in cease and desist orders and consent decrees in five securities violation actions brought in 1972 and 1973

by federal and California regulatory agencies. The work papers show that the face value of the trust deed notes securing appellant Vanderbilt Mutual Fund's Burreson debenture was less than the outstanding principal balance of the debenture. By December 31, 1973 Burreson had sold more than one-third of the trust deed note collateral to another defendant in this case, Sackman-Gilliland Corp., without the mutual fund's consent. Arthur Young, it is argued, would have discovered the wrongful sale of the missing notes if it had attempted to inspect them instead of relying on the word of the mutual funds' custodian.

> "Arthur Young's work papers show that it knew Oh Boy! Industries had an operating deficit of about $500,000 and a retained earnings deficit of almost $1,257,000 for 1973. The Oh Boy! debenture fixed a usurious interest rate under California law—11½%, which it bore on its face. The president of Oh Boy! Industries was also a director of each of the funds. The funds contend that these facts should have caused Arthur Young to qualify its opinion with regard to the Pegasus Income & Capital Investment Fund, Inc. financial statements, refuse certification, or seek a written opinion of counsel as to the legality of the purchase of the debenture."

Arthur Young, however, issued an unqualified opinion stating its examination had been made in accordance with generally accepted accounting principles and that the funds' financial statements "present fairly the net assets of [the mutual funds] at December 31, 1973 . . . in conformity with generally accepted accounting principles applied on a consistent basis." Al-

legedly as a result of this audit, certain fund directors were enabled to defraud the funds.

The District Court granted summary judgment for Arthur Young.[4] The Court of Appeals affirmed, holding plaintiffs had alleged no more than ordinary malpractice or negligence, despite the fact Arthur Young had allegedly breached a specific statutory duty under the Investment Company Act, 15 U.S.C. §80a-33(b). The court held the test of recklessness was "bad faith," and that "the greater specificity of Arthur Young's duty . . . does not imply that its breach was in bad faith or the result of recklessness." The court applied the "flexible duty" test of *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), to support its conclusion, stating that the auditor's duty of disclosure to the entity being audited was narrower than its duty to third parties.

The Pegasus Fund underscores the major points made in the petition for writ of certiorari:

(1) A recklessness standard for scienter makes uniform application of federal securities laws impossible. How could Petitioner be found reckless when it fully disclosed Marconsult's financial condition and issued a qualified opinion, and Arthur Young not be when it did not fully disclose and issued an unqualified opinion? If the recklessness standard is so inconsistent when applied by the courts, even greater unpredictability may be expected from juries.

(2) The flexible duty test of *White v. Abrams* has no place in §10(b) and Rule 10b-5 actions after *Hochfelder*. In *The Pegasus Fund*, footnote 1, the

[4]The opinion of the Court of Appeals does not indicate whether the District Court applied a recklessness or more stringent standard of scienter.

court stated: "There is considerable merit in the position taken by Judge Ferguson in his concurring opinion in *Spectrum Financial Companies, supra,* 608 F.2d 382-85 (Ferguson, J., concurring). A flexible duty standard that cannot include ordinary negligence within the circle of culpability resembles using a 36-inch ruler exclusively to measure distances never exceeding 24 inches."

The court in *The Pegasus Fund* supported its conclusion that only ordinary negligence was alleged by defining a narrow duty of disclosure on the part of Arthur Young. In the instant case, the court defined an expansive duty — not really even a duty of disclosure, but more precisely a duty to make a particular professional judgment (*i.e.*, that Marconsult was not a going concern) from fully-disclosed facts. In the instant case, the full 36-inch yardstick of the flexible duty standard was applied.[5]

(3) Under no definition of recklessness could Petitioner be found liable to Respondents consistent with *Hochfelder*. In *The Pegasus Fund*, unlike the instant case, the court made some effort to define recklessness in a manner consistent with *Hochfelder* as involving "bad faith." Clearly, under this standard, Petitioner could never be found liable for its alleged failure to describe Marconsult as not a going concern. Manifestly, any effort to define recklessness consistent with *Hochfelder* must also bar continuance of the present suit be-

[5]Respondents' suggestion that the flexible duty standard is other than a scienter substitute or alternative ignores its history and subsequent application. In *White v. Abrams*, the flexible duty negligence standard was expressly adopted to substitute for scienter. As seen in *The Pegasus Fund* and the instant case, the scienter requirement expands and contracts as the court's application of the flexible duty standard varies.

cause the District Court necessarily determined there was no material triable issue of fact regarding scienter as defined by *Hochfelder*.

In short, *The Pegasus Fund* eloquently demonstrates the paramount need for reaffirmation of *Hochfelder*, especially in the Ninth Circuit.

Conclusion.

For the reasons stated, Petitioner respectfully urges that this Court grant the petition for writ of certiorari to review the judgment and opinion of the Ninth Circuit Court of Appeals.

Respectfully submitted,

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APPENDIX A.

Opinion.

United States Court of Appeals for the Ninth Circuit.

THE PEGASUS FUND, INC., VANDERBILT MUTUAL FUND, INC., and PEGASUS INCOME & CAPITAL FUND, INC., Plaintiffs-Appellants, v. RONALD J. LARANETA, et al., and FEDERATED INVESTORS, INC., et al., Defendants, and ARTHUR YOUNG & COMPANY, Defendant-Appellee. No. 77-3450.

FILED Feb. 14, 1980.

Appeal from the United States District Court for the Central District of California.

Before: SNEED and TANG, Circuit Judges, and JAMESON,* District Judge.

SNEED, Circuit Judge:

The plaintiffs-appellants are three mutual funds that charge the defendant-appellee, an accounting firm, with recklessly performing an audit of the funds' financial statements in violation of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and rule 10b-5, 17 C.F.R. § 240.10b-5. This appeal is taken from summary judgment on pleadings that alleged only a rule 10b-5 violation, although a memorandum submitted in opposition to the motion for summary judgment alluded to the possibility of a private claim under section 34(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-33(b). The appellee has moved this court to dismiss a portion of the appeal that challenges

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*Honorable William J. Jameson, Senior United States District Judge for the District of Montana, sitting by designation.

the allegedly implicit summary judgment on the section 34(b) claim and to strike the corresponding part of the plaintiffs-appellants' brief. By previous order of this court the motion is to be considered with the merits of the appeal. Our jurisdiction rests on 28 U.S.C. § 1291. We grant the appellee's motion to dismiss the section 34(b) portion of the appeal and affirm the summary judgment.

I.
FACTUAL SETTING

The appellants are investment companies, or mutual funds, registered in accordance with the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* As a result of several transactions during 1973, each mutual fund bought a restricted debenture of Burreson & Co., Inc., secured by deeds of trust on realty whose value exceeded the fact value of the debentures. One of the appellants, Pegasus Income & Capital Fund, Inc. (PIC), also purchased an Oh Boy! Industries Inc. restricted debenture and a block of its convertible preferred stock. Since none of the securities were traded on any exchange and all were restricted, the directors of the funds had a duty, under 15 U.S.C. § 80a-2(a)(41) and 17 C.F.R. § 270.2a-4(a)(1), to value them. Each board met and valued the debentures at cost, which was also the face value of the securities. PIC valued its Oh Boy! Industries preferred stock at 95% of face value in view of the acknowledged weakness of the issuer.

As required by 15 U.S.C. § 80a-29(e), the directors of the mutual funds made arrangements for an audit of their financial statements. The appellee Arthur Young was the accounting firm chosen for the task.

The mutual funds gave Arthur Young copies of various documents from their files, including:

(a) the Burreson & Co. and Oh Boy! Industries securities, the latter of which showed on its face an interest rate of 11½%;

(b) a preliminary draft of a Burreson & Co. financial statement as of June 30, 1973 as to which the company's auditor had disclaimed any opinion;

(c) an audited financial statement of Oh Boy! Industries as of May 31, 1973 as to which the auditor had expressed an unqualified opinion;

(d) security agreements underlying the Burreson & Co. debentures, listing trust deed collateral.

Arthur Young certified the appellants' financial statements without qualification, stating in part: "We have examined the accompanying [financial statements] . . . . Our examination was made in accordance with generally accepted auditing standards . . . [and] . . . the [mutual funds'] statements . . . present fairly the net assets of [the mutual funds] at December 31, 1973 . . . in conformity with generally accepted accounting principles applied on a consistent basis." By that date, however, the appellants allege that the Burreson and Oh Boy! securities were practically worthless.

After receiving the audit opinion, the mutual funds bought, on the recommendation of their investment advisors, securities issued by Commercial Petro-Gas, Inc. (CPG); and North American Credit Corp. (NACC described in the mutual funds' pleadings as Burreson & Co. affiliates. Arthur Young has made the uncontro-

verted allegation that it was unaware of any connection between CPG, NACC and Burreson & Co. Interlocking directorates permitted some of the mutual funds' directors to defraud the funds by channeling the investment capital of the funds into corporations the directors owned or controlled. The mutual funds do not contend that Arthur Young was a participant in or beneficiary of these schemes.

An alleged basic flaw in the audit, which the mutual funds assert was recklessly done, was Arthur Young's failure to advise the mutual funds that the debenture collateral consisted not of first deeds of trust but of "all-inclusive" deeds of trust, which the funds say represent junior security interests. Arthur Young maintains that all-inclusive deeds of trust can represent first or second mortgages. The partner of Arthur Young responsible for the audit testified in related SEC proceedings that he did "know what [first deeds of trust] are." While the accounting firm inspected the restricted securities in the custody of California Bankers Trust Co. (CBT), the custodian of the mutual funds' assets, it accepted CBT's written and oral assertions that the related collateral documents were first deeds of trust.

The mutual funds note several other warning details that they allege a proper audit would have revealed. Some of these concern the Burreson debentures, and others concern the Oh Boy! debentures and convertible preferred shares. The following allegations belong to the first group:

> Arthur Young's work papers for the audit disclosed that Burreson & Co. had an accumulated net worth deficit of over six million dollars and was delinquent in interest and principal payments on certain trust deed notes in the amount of

> $370,000 as of April 30, 1973. These notes were secured by the same realty that secured the plaintiff's debentures, and represented a superior claim to that collateral. The work papers reflect that Burreson had been and was still running at a loss as of the date of the audit opinion. Financial statements included in the work papers revealed that Burreson had been a party charged in cease and desist orders and consent decrees in five securities violation actions brought in 1972 and 1973 by federal and California regulatory agencies. The work papers show that the face value of the trust deed notes securing appellant Vanderbilt Mutual Fund's Burreson debenture was less than the outstanding principal balance of the debenture. By December 31, 1973 Burreson had sold more than one-third of the trust deed note collateral to another defendant in this case, Sackman-Gilliland Corp., without the mutual funds' consent. Arthur Young, it is argued, would have discovered the wrongful sale of the missing notes if it had attempted to inspect them instead of relying on the word of the mutual funds' custodian.

The allegations relating to the Oh Boy! Industries' securities are these:

> Arthur Young's work papers show that it knew Oh Boy! Industries had an operating deficit of about $500,000 and a retained earnings deficit of almost $1,257,000 for 1973. The Oh Boy! debenture fixed a usurious interest rate under California law—11½%, which it bore on its face. The president of Oh Boy! Industries was also a director of each of the funds. The funds contend that these facts should have caused Arthur Young to

qualify its opinion with regard to the Pegasus Income & Capital Investment Fund, Inc. financial statements, refuse certification, or seek a written opinion of counsel as to the legality of the purchase of the debenture.

The persons responsible for the fraudulent scheme were officer-directors of the mutual funds. Several have been convicted of conspiracy and violations of the federal securities laws. At least one disinterested director on the boards of all three mutual funds professes that he relied on the audit in approving the continued use of investment managers controlled by directors involved in the fraud.

Notwithstanding these allegations and assertions by the mutual funds, the district court on the basis of the record before it found that the following facts, *inter alia,* were not in genuine dispute:

11. Arthur Young did not make any statement to the plaintiffs, either in its audit opinion respecting each Fund or during the course of the respective audits, regarding the legality of PIC Fund's purchase of Oh Boy! securities.

12. Arthur Young did not make any statement to plaintiffs, at any time herein, either in its audit opinion with respect to each Fund or during the course of each audit, that the value of the Burreson debentures as of December 31, 1973 were equal to their face value.

13. Arthur Young did not make any statement to the plaintiffs at any time herein, either in the audit opinions respecting each Fund or in the course of each respective audit, that the value of the Oh Boy! securities as of December 31, 1973 was equal to $872,500.

14. At no time during the course of its audit of the financial statements of each of the respective Funds did Arthur Young know that the Funds were considering the purchase of securities issued by either North American Credit Corporation ("NACC") or Commercial Petro-Gas ("CPG"). Arthur Young only learned of such purchases after the Funds had consummated the acquisitions.

15. At no time during the course of its audit of each of the respective Funds, nor at any time prior to the commencement of the investigation of other defendants herein by the Securities and Exchange Commission in July 1974 did Arthur Young know that either NACC or CPG were affiliated in any manner with Burreson. Arthur Young learned for the first time in January, 1977 that CPG's former name had been Burreson Petro-Gas and that NACC's former name had been Burreson Investment Co., Inc., and that the names of CPG and NACC were changed in January, 1974 just prior to the first of the Funds' subsequent purchases of securities of the newly named companies.

16. During the course of its audit of each of the respective Funds, personnel of Arthur Young were advised by Ronald J. Laraneta, Chairman of the Board of Directors of each plaintiff, Michael E. Long, President of each plaintiff, and Joseph J. Laraneta, a member of the Board of Directors and Executive Vice President and Treasurer of each Fund, that first trust deeds on real property secured the Burreson debentures purchased by plaintiffs in 1973.

17. By letter dated January 31, 1974 the custodian of assets of each of the Funds, California

Bankers Trust Company ("CBT"), acting pursuant to the request of the Funds, confirmed in writing to Arthur Young through the Vice President of CBT, Fred J. Straeter, that CBT had in its possession first trust deeds as collateral for the Burreson debentures owned by plaintiffs. Shortly thereafter, Arthur Young personnel met and discussed the subject confirmation letter, including the collateral balances as confirmed to Arthur Young by CBT, with Joseph J. Laraneta, the then Executive Vice President and Treasurer of each Fund.

18. During the course of its 1973 audits of the Funds Arthur Young knew of no inadequacies in the internal controls of CBT.

19. During 1973 Pietro Vitale was a member of the Board of Directors of both Pegasus and Vanderbilt. Both such Funds knew that Mr. Vitale was also President of Oh Boy!, in that Mr. Vitale was so identified in a Notice of Annual Meeting of Shareholders dated March 19, 1973 issued respectively for Pegasus and Vanderbilt. Mr. Vitale was also so identified and described in Vanderbilt's Semi-Annual Report dated June 30, 1973, Third Quarter Report dated September 30, 1973, and its Annual Report dated December 31, 1973. Similarly, PIC Fund was aware that Pietro Vitale was the President of Oh Boy! in that the Oh Boy! financial statements in the possession of PIC Fund during the year 1973, and which were provided to Arthur Young by the Funds, so identify Mr. Vitale. Moreover, the following individuals were members of the Board of Directors of PIC Fund in 1973:

Ronald J. Laraneta	Michel E. Long
Miller H. Hurt	Joseph J. Laraneta
Jack H. MacDonald	Mell M. Barton
Roy F. McNeill	John L. Moore
John E. Nevins, Jr.	Edward O. Stevenson

Each of the members of the Board of Directors of PIC Fund was also a member of either or both of the Board of Directors of Pegasus and Vanderbilt in 1973 along with Mr. Vitale.

20. In January, 1974, Arthur Young physically inspected and counted each Burreson debenture and the Oh Boy! securities owned by the Funds and in the custody of CBT, their custodian of assets.

C.R. 1416-19.

II.

THE 10b-5 CLAIM

Summary judgment is proper only if two conditions are met: The pleadings, depositions, etc., obtained in discovery must show that there is no disputed issue of material fact, and on the agreed facts the moving party must be entitled to prevail as a matter of law. Fed. R. Civ. P. 56(c). The movant has the burden of showing there are no genuine factual issues, and evidence is construed in the manner most favorable to the opponent. Although the extent to which Arthur Young adhered to proper auditing procedures is clearly disputed, we agree with the district court that no genuine dispute exists as to any material fact relevant to the 10b-5 claim. Arthur Young acted without

the quality of intent required for a violation. A brief review of the allegations and evidence submitted below will demonstrate this.

Arthur Young knew nothing of the connection between Burreson & Co. and the corporations whose securities the mutual funds complain the audit opinion induced them to buy, nor was Arthur Young aware that the mutual funds were disposed to purchase these securities. Directors of the mutual funds and the custodian of their assets assured Arthur Young that first trust deeds secured the Burreson debentures. There was no cause to suspect the internal controls of CBT. In the course of the audit Arthur Young physically inspected the Burreson and Oh Boy! securities in CBT's custody. In other words, the claim against Arthur Young rests on allegations that the audit was not sufficiently thorough. There is no suggestion that Arthur Young knew fraud was afoot or had any motive for not probing more deeply. The mutual funds argue, as they must, that Arthur Young's failure to discover the fraud nonetheless fell so far short of professional standards as to constitute reckless conduct.

This court has held, in response to the Supreme Court's decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976) (scienter required for Rule 10b-5 violation but the question whether recklessness suffices reserved), that reckless misrepresentation of the facts pertinent to a securities transaction will ground a rule 10b-5 claim. *Nelson v. Serwold,* 576 F.2d 1332, 1337 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978). What constitutes recklessness, however, is not a question to be answered by simple reference to tort doctrines. In analyzing section 10(b), its legislative history, and rule 10b-5, the Court in *Hochfelder*

formulated the issue as whether Congress intended to create liability predicated on "a failure to exercise reasonable care" or to permit "good faith" as an "absolute defense." 425 U.S. at 200. The Court's answer: "There is no indication that Congress intended anyone to be made liable [under rule 10b-5] unless he acted other than in good faith. The catchall provision of § 10(b) should be interpreted no more broadly." *Id.* at 206. We find this language especially significant for cases that, like *Hochfelder,* grow out of injuries perhaps partly attributable to inadequate accounting performance. By referring to the good faith defense, the Court meant, we believe, to reinforce and clarify the distinction between ordinary malpractice resting on negligence, on the one hand, and fraud, on the other. We agree with the appellee that the issue before us is whether the mutual funds have alleged anything more than ordinary malpractice.

We think they have not. This conclusion draws support from the flexible duty standard employed by this circuit. *See Spectrum Financial Companies v. Marconsult, Inc.,* 608 F.2d 377, 381 (9th Cir. 1979); *Crocker-Citizens National Bank v. Control Metals Corp.,* 566 F.2d 631, 636 n.2 (9th Cir. 1977); *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974). The scope of one's duty under rule 10b-5 is analyzed with reference to

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

Id. at 735-36 (citations omitted). All these factors suggest that the relationship of an auditor to the firm it audits creates a narrow duty of disclosure. The relationship itself is occasional. The auditor's access to information about the firm depends to a greater or lesser degree on the firm's producing documents under its control. The auditor's benefit from the relationship consists in a fee for professional services. While the auditor may know that persons dealing with the firm and the firm's own directors will rely in some ways on the audit opinion, rarely if ever can the firm itself be expected to base investment decisions on what an audit reveals. *See Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811, 815 (2d Cir. 1975). Reckless disregard of this narrow duty is conduct of an extreme sort and should be found sparingly. To do otherwise would be to impose a more far-reaching duty than the facts of this case justify.[1]

Our recognition of the need for caution in characterizing Arthur Young's alleged auditing deficiencies is reinforced by a comparison of the *Hochfelder* facts with those before us. In *Hochfelder* the defendant accounting firm failed to discover that the president of a small brokerage, for which it performed the annual audits required by section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78q(a), had permitted no one but himself to open mail addressed to the firm even if it arrived in his absence. Plaintiffs characterized

[1]There is considerable merit in the position taken by Judge Ferguson in his concurring opinion in *Spectrum Financial Companies, supra,* 608 F.2d 382-85 (Ferguson, J., concurring). A flexible duty standard that cannot include ordinary negligence within the circle of culpability resembles using a 36 inch ruler exclusively to measure distances never exceeding 24 inches.

the failure to discover this "mail rule" as negligence, specifically disclaiming any theory of intentional misfeasance. The Court found the allegations insufficient. In the present case the failure was also a failure to investigate and also occurred in the course of a normal audit. Here as in *Hochfelder* the scope of the auditor's duty was partly determined by federal statute: in *Hochfelder* by 15 U.S.C. § 78q(a), and in this case by 15 U.S.C. § 80a-33(b). SEC Release No. 118, 5 Fed. Sec. L. Rep. (CCH) ¶ 72,140, at 62,296 and AICPA, Industry Audit Guide: Audits of Investment Companies 47 (1973) also are relevant to the scope of Arthur Young's duty. This duty was arguably more specific than was the auditor's duty in *Hochfelder*, for whereas Ernst & Ernst neglected to inquire into day-to-day procedures of the subject brokerage, Arthur Young allegedly failed to examine a statutorily required action on the part of plaintiffs' directors, as the Investment Company Act evidently contemplated that an auditor shall. *See* 15 U.S.C. § 80a-33(b). The greater specificity of Arthur Young's duty, however, does not imply that its breach was in bad faith or the result of recklessness. Even a custom or statutory directive that an auditor who accepts a particular sort of commission must perform a certain "ministerial" accounting task cannot ground the inference that corrupt motives underlie every failure to perform that task. We quite agree that the recklessness that rule 10b-5 requires must come "closer to being a lesser form of intent [to deceive] than merely a greater degree of ordinary negligence." *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977); *cf. Lewelling v. First California Co.*, 564 F.2d 1277, 1281 n.6 (9th Cir. 1977) (scienter is absent whenever the party charged with liability was not aware

of a fraudulent scheme) (dictum). At best only ordinary negligence is charged here.

III.

THE SECTION 34(b) CLAIM

The mutual funds have argued in their appeal that the summary judgment against them was improper in view of their claim under section 34(b) of the Investment Company of 1940, 15 U.S.C. § 80a-33(b). It is doubtful that this section implies a private cause of action. *See Transamerica Mortgage Advisors, Inc. v. Lewis,* 48 U.S.L.W. 4001, 4004 n.13 (U.S. Nov. 13, 1979) ("Congress amended the Investment Company Act in 1970 to create a narrowly circumscribed right of action for damages *against investment advisers* to registered investment companies" (emphasis added)).

In any event, the issue was not adequately raised in the proceedings below and therefore is not before us. *Michael-Regan Co. v. Lindell,* 527 F.2d 653, 659-60 (9th Cir. 1975). At best, the mutual funds called attention to the claim only in a memorandum opposing Arthur Young's motion for summary judgment. The memorandum mentions section 34(b) in an argument disputing the preemption of the rule 10b-5 action by section 18 of the 1934 Act, 15 U.S.C. § 78r. No complaint relied on section 34(b), no findings with respect to the claim were made nor were any requested. No objection to the absence of any such findings was made nor did appellants mention the claim in their notice of appeal. Under these circumstances we decline to consider it here. *See Babb v. Schmidt,* 496 F.2d 957 (9th Cir. 1974).

Affirmed.